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Treasury Committee

Quantitative Tightening: Government, Bank of England and Debt Management Office Reponses to the Committee's Fifth Report

Third Special Report of Session 2023–24

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The Treasury Committee

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Third Special Report

The Treasury Committee published its Fifth Report of Session 2023–24, *Quantitative Tightening* (HC 219), on 7 February 2024. Responses have been received from HM Treasury on 5 April, the Bank of England on 5 April and the Debt Management Office on 25 March. Those responses are appended to this Report.

The Committee welcomes the detailed nature of the responses but is disappointed that none of its recommendations has been fully accepted. The Committee will seek to monitor areas in which the responses have been less substantial. Those include, but are not limited to: the long-term steady-state size and composition of the Bank's balance sheet; quarterly analysis of the impact of Quantitative Tightening; a contingency in case the Bank should have to resort to asset purchases for financial stability reasons in future; value for money arising from individual rounds of Quantitative Easing; and whether value for money can be taken into account for decisions about the scale and pace of Quantitative Tightening.

Appendix 1: Response from HM Treasury

Letter from HM Treasury

Dear Dame Harriett,

I am writing to respond to the Committee's inquiry into quantitative tightening (QT). I am grateful to the Committee for its report.

The issues you raise in the report tackle a wide range of issues relating to the governance, implementation, and fiscal costs of QT. Your recommendations are appreciated and have been carefully considered. The annex to this letter responds to all recommendations directed at HM Treasury. Along with a response from the Bank of England and the Debt Management Office, these returns will ensure that the Committee has a full response to its important report.

I would like to thank you again for your Committee's work.

Best wishes,

RT HON JEREMY HUNT MP

Chancellor of the Exchequer

Before addressing the Committee's specific recommendations, it is worth setting out some overarching comments.

Price stability is essential for a strong economy, and by extension strong public finances. It is widely recognised that an operationally independent central bank is the best way to achieve price stability. This is why the UK's macroeconomic framework enshrines the Bank of England's operational independence for monetary policy in law, with price stability as the primary objective of the Monetary Policy Committee (MPC), as set by the government. The monetary policy decisions of an independent central bank will always have fiscal implications, through their impact on the economy and inflation. However, to retain the effectiveness of monetary policy, it is important for the fiscal authority not to undermine, or be perceived to undermine, the independence of the central bank. The Treasury adheres to this principle by, among other things, declining to comment on the conduct or effectiveness of monetary policy.

The Memorandum of Understanding (MoU) established in 2018 on the financial relationship between the Treasury and the Bank reinforces its independence and resilience by providing a clear capital and income framework for the Bank as well as principles for operations that should be indemnified by the Treasury.[1] This allows the Bank to retain its focus on its objectives and provides clarity, predictability, and accountability on the appointment and management of the associated financial risks.

Unconventional monetary policies, including quantitative easing (QE) and quantitative tightening (QT), have direct fiscal consequences, including through cashflows arising from the indemnity of the Asset Purchase Facility (APF). The presumption is that the financial risks of unconventional monetary policy operations will be borne by the Treasury where

1 Financial relationship between the Treasury and the Bank of England, 2018

exposures exceed the Bank's capital, with assessments for the financial backing done on a case by case basis as set out in the MoU. Notwithstanding these risks, the Treasury's underlying principle remains the same: independent monetary policy is essential for macroeconomic credibility, and therefore beneficial for the economy and public finances.

When assessing value for money and considering the overall fiscal impact of QE, as noted by the OBR, the impact on the wider economy and public finances must be accounted for. Evaluating the overall value for money of monetary policy decisions on an ongoing basis would not support the MPC's ability to conduct monetary policy independently, or deliver its price stability objective. However, we keep the design of the framework in which those policy decisions are made under review.

The Treasury will continue to work with the Bank to ensure that, once monetary policy decisions are made by the independent MPC, monetary policy operations maximise value for money and minimise market disruption.

Steady state balance sheet

As the Committee refers to in their report, there are a set of important issues the Bank is likely to face as APF unwind continues. Across several speeches, former Executive Director for Markets at the Bank, Andrew Hauser, set out these challenges including supplying the right amount of central bank reserves to the market, transmitting the MPC's policy rate decisions into the real economy, and doing so whilst maintaining financial stability.

The market notice issued by the Bank in August 2022 outlined the mechanics of the Bank's planned APF gilt sales, as well as the Bank's new Short Term Repo facility (STR) and the potential long run composition of assets on its balance sheet.[2]

The APF unwind profile will continue to be determined by the independent MPC. As has been the case, subject to the MPC's policy objectives, the Bank's operations in respect of the APF and its unwind will continue to be governed, designed and risk managed with the aim of minimising cost and risk.

These are important issues and the Treasury is engaging with the Bank on them, including to understand both the short and long-term implications arising from material changes to the Bank's balance sheet and how the Bank will meet its statutory monetary policy and financial stability objectives. As in the UK, major central banks internationally are reviewing the future shape of their balance sheets. Any changes will be communicated at the appropriate time.

Value for money and HM Treasury spending power

The Committee highlighted value for money and the importance of considering HM Treasury spending power throughout QT. First, we would like to set out a distinction between the decisions taken by the MPC and the operational implementation of QT by the Bank Executive.

The MPC has statutory independence to set monetary policy to pursue its objectives, as set in law and specified by the government. As above, the separation of fiscal and monetary

2 Asset Purchase Facility: Gilt Sales – Provisional Market Notice 4 August 2022; Explanatory Note: Managing the operational implications of APF unwind for asset sales, control of short-term market interest rates and the Bank of England's balance sheet

policy is a key feature of the UK's economic framework and essential for the effective delivery of monetary policy. This applies to conventional monetary policy (setting Bank Rate) and unconventional monetary policy, such as QE and QT, where the Treasury's indemnity of the APF has more direct fiscal effects. It is right that fiscal incentives do not influence the MPC's decision making, because actual or perceived fiscal influence on monetary policy decisions could result in significant costs to UK macroeconomic credibility. Bank of England independence and the ability to credibly signal a commitment to price stability has helped achieve lower rates of inflation on average since independence was granted.

Further, with a given set of market determinants there is little evidence that a different pace of sales would reduce cashflows between HMT and the APF or achieve better value for money. Profits or losses from QT are driven in the first instance by movements in gilt prices and Bank Rate. As demonstrated by the Bank in its quarterly APF reports, different APF unwind paces will impact the time profile of when losses are incurred but are expected to have little effect on total cost in present value terms.[3] Therefore while a faster pace of sales will realise losses sooner, all else equal, holding gilts for longer is unlikely to avoid these losses. Instead a higher net interest cost is incurred from holding the portfolio for longer (where Bank Rate paid on reserves is higher than coupon income). In addition, and as noted by the OBR, QT will help re-insulate the public finances against changes in borrowing costs by reversing the effect of QE on the UK's average debt maturity.[4]

More broadly, the independent MPC has been clear in its three principles underpinning QT. These set out the use of Bank Rate as the active monetary policy tool, the intention to conduct sales so as not to disrupt the functioning of financial markets, and conducting sales in a relatively gradual and predictable manner. By increasing predictability for market participants, for example through publication in advance of a gilt sales calendar and setting out the operational terms for QT sales, this approach should minimise any potential impact on the gilt market. The MPC's QT principles provide the market with clarity and predictability over the long term, helping to minimise cost and risk in the implementation of QT and support value for money.

The Treasury works closely with the Bank of England to ensure value for money in the implementation of QT. Once decisions on the pace of unwind and the key principles around them are made by the MPC, the Bank Executive is responsible for implementing the policy. The Governor's letter to the Chancellor on 28 April 2023 outlines existing measures in place and states that, subject to meeting the independent MPC's policy objectives, the Bank's operations in respect of the APF are governed, designed and risk managed with the aim of minimising cost and risk.[5] The measures include designing its gilt auctions to maximise demand and competition with multi-stock auctions and built-in price protections. The Bank also liaises closely with the Debt Management Office (DMO) to ensure its operations do not impact on the government's wider gilt issuance strategy. This is accompanied by comprehensive governance, reporting and transparency arrangements with the Treasury.

Nonetheless we recognise the Committee's concerns regarding clarity of who and how value for money considerations are taken into account. The Bank has made clear that its

3 See chart 3: APF cash flows (actual and projected), Asset Purchase Facility Quarterly Report - 2023 Q4
4 See box 4.3, OBR Economic and fiscal outlook – March 2024
5 Letter from the Governor to the Chancellor - April 2023

operations, as carried out by the Bank Executive, should maximise value for money by minimising cost and risk over the lifetime of the APF, subject to achieving the MPC's chosen unwind target and in line with the MPC's key principles.

Chancellor's authorisation

The Committee asked HM Treasury to clarify the role of the Chancellor's authorisation for changes in the APF indemnity. Firstly, we would like to be clear that the MPC has operational independence to achieve its monetary policy objectives, and can vote for any policy it assesses will best achieve those objectives, including QE. The Chancellor's authorisation relates to the Treasury's indemnification of the APF, as a vehicle to implement the MPC's policy decisions.

The Chancellor may authorise increases to the maximum size of the APF under the indemnity, being ultimately responsible to parliament for the spending implications. Each increase during successive rounds of QE was accompanied by Accounting Officer advice assessing the change against the Managing Public Money framework given the potential direct implications for public funds through the contingent liability created by the indemnity. This includes assessments for regularity and propriety, and assessments of the expected fiscal and macro-economic impact. This rightly reflects the responsibility on HM Treasury to properly assess the case for committing new public expenditure through expanding the APF indemnity and the associated contingent liability. The assessment does not assess decisions taken by the MPC in the first instance, but the increased contingent liability for the exchequer of an expanded APF. The Chancellor supports the MPC's independence to achieve its monetary policy objectives, and each increase in the contingent liability from the maximum authorised size of the APF supported the MPC using QE to achieve those objectives.

Since the MPC voted to unwind the APF in February 2022, the maximum authorised size of the APF indemnity has been reduced accordingly. As agreed in an exchange of letters between the Chancellor and the Governor, this takes places every six months.[6] Reductions to the maximum size of the indemnity similarly reduce the size of the contingent liability for government. As such the Chancellor's decision does not require the same risk assessment during unwind.

The Committee also asked whether there is a threshold at which the indemnity would not be provided. It is important to note that each decision by successive Chancellors to increase the maximum authorised size of the APF was done on a case-by-case basis. Each MPC decision to implement QE, for example in response to the pandemic and following the global financial crisis, was made in the context of Bank Rate already close to or at the effective lower bound. It was open to the Chancellor, and would be open to future Chancellors not to approve increases to the maximum authorised size of the APF under the indemnity if they did not consider the expansion value for money.

Accounting for QT losses

The Committee recommended that HM Treasury and the Bank review whether it is appropriate that indemnity payments are included in the debt metric targeted by the fiscal rules.

6 Exchange of letters between the Governor and the Chancellor on the Asset Purchase Facility - February 2022

Sustainable public finances provide the foundations for long-term growth, and the government remains committed to reducing debt. The current rules require public sector net debt excluding the Bank of England to be falling and borrowing to be below 3% of GDP, both in the fifth year of the rolling forecast period. Fiscal rules are designed and managed by the Treasury and are not a matter for the Bank of England.

In achieving the best measure of fiscal sustainability, it is the government's position that substantial fiscal costs should not be excluded from the debt metric target. Realised losses on sales and the net interest costs arising from the APF are real fiscal impacts for the public sector as a whole. Regardless of how specific cashflows between the Treasury and the Bank are arranged, ignoring such costs would mean targeting fiscal metrics that do not reflect a comprehensive assessment of the public sector's fiscal position.

The Committee also asked about alternative accounting approaches for recording gains and losses from QE, as well as the 2012 decision to remit cashflows on a quarterly basis. While the Federal Reserve in the US records losses from QE as a deferred asset on its balance sheet, this reflects the specific financial and institutional set up of the US central bank. The Treasury's indemnity of the APF is in line with the MoU on the financial relationship between the Treasury and the Bank of England.[7] The advantages of this set up were outlined by HM Treasury at the Autumn Statement 2023 in Box 1.E, and are in line with best practice as set out in a recent IMF working paper relating to several areas of governance, accountability and transparency.

Excess cash from asset purchases between 2009 and 2012 initially accrued in the APF. When it became clear that asset purchases under QE were likely to be held for longer and at a larger scale than initially envisaged, the government decided to normalise the cash management arrangements such that any excess cash would be transferred to the Treasury on a quarterly basis. The cash transfers from the APF to the Treasury that took place until 2022 helped reduce the government's cash requirement and the amount of gilts that would need to be issued by the DMO, therefore reducing the government's future debt interest costs and supporting the overall position of the public finances. Had the initial arrangement remained in place, the excess cash held in the APF would have received interest at Bank Rate, which was close to zero between 2009 and 2021. The Treasury will of course keep under review its approach to best manage cashflows and consider any lessons learned in the future should QE be deployed again.

7 Financial relationship between the Treasury and the Bank of England, 2018

Appendix 2: Response from Bank of England

Letter from the Bank of England

Dear Harriett,

Your report of 7 February 2024–"Quantitative Tightening"

I wish to thank you for the Treasury Committee's report on the process of unwinding the asset purchases conducted by the Bank of England under its policy of quantitative easing (QE), also referred to as quantitative tightening (QT). The Bank welcomes the report and its broad finding that the Bank's strategic framework for QT is reasonable.

Before addressing each of the specific recommendations made in the report (in the Annex to this letter), I would like to make a few general points in response to the Committee's findings.

The MPC's strategy for unwinding the stock of asset purchases was outlined in the August 2021 Monetary Policy Report.[8] This strategy is guided by three key principles. First, Bank Rate is the preferred active policy tool for adjusting the monetary policy stance. Second, sales of assets accumulated during QE should be conducted in a manner that does not disrupt the functioning of financial markets. And third, sales of assets should be conducted in a gradual and predictable manner over time.

The MPC's preference for using Bank Rate as its active policy tool derives from its view that such actions are more effective and operationally simpler to implement. This preference is also based on long experience of using Bank Rate.

On this basis, the MPC has developed a greater understanding of how changes in Bank Rate affect the economy, relative to its knowledge of the impact of other monetary policy tools.

The MPC views the impact of QE and QT on the economy and inflation as working largely through their effects on asset prices.[9] The MPC regularly reports discussion and analysis of market and asset price developments in the Monetary Policy Report and in the minutes of its meetings. In doing so, the MPC offers an assessment of how QE and QT are influencing the outlook for the economy and inflation, embedded within an overall analysis of the evolution of monetary and financial conditions.

To the extent that QE and QT work through their influence on asset prices and financial conditions, their impact is incorporated into the MPC's quarterly macroeconomic forecasts, which are conditioned on those asset prices. By ensuring that QT is announced transparently and conducted in a predictable manner, asset prices should incorporate any impact from an anticipated reduction in the stock of asset purchases, just as they incorporate other macroeconomic news and developments.

8 https://www.bankofengland.co.uk/monetary-policy-report/2021/august-2021

9 https://www.bankofengland.co.uk/quarterly-bulletin/2022/2022-q1/qe-at-the-bank-of-england-a-perspective-on-its-functioning-and-effectiveness

In this setting, decisions on Bank Rate that are based on the MPC's macroeconomic forecasts will naturally take any impact of QT on monetary and financial conditions into account. And since the forecasts are conditioned on prevailing asset prices, the MPC's framework for conducting monetary policy is robust to the uncertainties in the transmission of QE and QT decisions that we inevitably face.

Given the preference to use Bank Rate as the active policy tool on a meeting-to-meeting basis grounded in these arguments, it is natural that the MPC discusses the parameters governing its QT programme on a less frequent basis, in the form of a scheduled annual review. In addition, annual reviews serve the purpose of supporting gradual and predictable decisions on the QT programme in line with the key principles outlined above.

Decisions on the target stock of assets held for monetary policy purposes in the Bank's Asset Purchase Facility (APF) are taken independently by the MPC. These decisions are taken solely to meet the 2% inflation target. The APF is indemnified by HM Treasury to ensure that the MPC can take its decisions in this way, in line with its statutory price stability objective and the remit given to it by the Government.

Subject to the MPC's ability to pursue its monetary policy objectives independently in this manner, the Bank of England's obligation to ensure that the unwind of asset purchases shows 'value for money' is reflected in the Bank's design and implementation of QT operations.

These are governed, designed and risk managed with the aim of minimising cost and risk. I set these out in more detail in my letter to the Chancellor in April 2023 and in my letter to you in December.[10][11]

The direction and magnitude of cashflows between HM Treasury and the APF is discussed at length in your report. In the past, there have been large cashflows from the APF to HM Treasury. In more recent times, the direction of those flows has reversed. This was expected at the time the arrangements governing the indemnity were put in place. The Bank has been fully transparent about APF cashflows and presents a set of cashflow projections in the APF Quarterly Reports. Future APF cashflows are highly uncertain, however, and are sensitive to several factors. It is also important to note that the fiscal implications of QE and QT are not simply captured by cashflows between the APF and HMT, but also through the wider impact of the policy on financial conditions and the economy. The OBR, for example, noted in November that its assessment of lifetime cashflows associated with QE and QT did not amount to an assessment of the overall fiscal, let alone economic, impacts of QE, which reduced borrowing costs, lowered unemployment, supported the economy and helped stem disinflationary pressures at various points over the past 15 years.

With regard to the future Bank's balance sheet arrangements in steady state, in September 2022 the Bank set out its arrangements for allowing the MPC to focus solely on monetary policy considerations in setting its strategy for unwinding its stock of asset purchases.[12] These arrangements are designed such that the MPC could, over time, if it judged this necessary for policy reasons, unwind the APF fully in line with the gradual and predictable approach that it has previously articulated. It does not state that QT would cease at a

10 https://www.bankofengland.co.uk/-/media/boe/files/letter/2023/governor-apf-letter-april-2023.pdf

11 https://committees.parliament.uk/publications/42867/documents/213069/default/

12 See https://www.bankofengland.co.uk/markets/market-notices/2022/august/explanatory-note-on-operational-implications-of-apf-unwind

certain level of reserves, nor does it rule out other choices. Decisions on the size, shape and future risk profile of our future balance sheet will be made in close consultation with HM Treasury and relevant stakeholders and communicated in a transparent manner.

QT is only one factor behind the normalisation of the Bank's balance sheet. Reserves may also fall for other reasons, most notably repayments of loans made under the Bank's Term Funding Scheme with additional incentives for small and medium-sized enterprises (TFSME). A reduction in the size of the Bank's balance sheet has implications for the operation of the financial system, notably when the stock of reserves will eventually approach the level needed by banks. To help ensure that short-term market rates remain close to Bank Rate the Bank has launched a Short-Term Repo (STR) facility which allow the MPC to make future decisions about APF unwind independently of the implications for the supply of reserves.

The Bank is also taking action in line with its statutory duty to protect and enhance the financial stability of the UK financial system. The FPC has set out the actions it is taking, both domestically and in conjunction with international work, on addressing the risk of severe dysfunction in core sterling markets when there is a threat to UK financial stability. Front and centre in this strategy was the need for stronger private self-insurance, market infrastructure and liquidity regulation. Primary responsibility for ensuring appropriate resilience to the wide and evolving range of idiosyncratic liquidity risks lies with firms themselves.

More generally, I welcome the report's conclusion that the Bank is right to develop a new backstop facility to reduce the risk of having to resort to gilt purchases in future. This work will support the Bank's readiness to respond to any future market stresses that might arise and threaten financial stability. The Bank's work in this space include facilities to lend to non-bank financial institutions, for the purpose of addressing severe dysfunction in core sterling markets when there is a threat to UK financial stability and existing facilities cannot channel sufficient liquidity to the financial system as a whole.[13] The Bank is working at pace to launch an initial version of this facility, which will lend cash in exchange for gilts to eligible insurance companies and pension funds (ICPFs), including associated LDI funds. Nevertheless, there may be instances where a lending facility alone is not sufficient to address market dysfunction. Alongside the work to develop the new lending facility, the Bank is working to learn lessons from the September 2022 intervention.[14]

Carrying out operations in the gilt market is a core function of the Bank that contributes towards delivering on its monetary and financial stability objectives. However, operations designed to fulfil financial stability objectives, such as those during October 2022, are different in nature to QE or QT which are conducted for monetary policy purposes and in line with the MPC's remit.

The MPC agreed that there would be a high bar for amending the planned reduction in the stock of gilts purchased for monetary policy purposes outside a scheduled annual review. This is consistent with the design principles of QT in that gilt sales should be gradual,

13 https://www.bankofengland.co.uk/speech/2023/september/andrew-hauser-speech-at-market-news-international-connect-event and https://www.bankofengland.co.uk/speech/2024/march/nick-butt-keynote-speech-at-isda-virtual-conference-procyclicality-and-margin-practices

14 https://www.bankofengland.co.uk/quarterly-bulletin/2023/2023/financial-stability-buy-sell-tools-a-gilt-market-case-study

predictable and not disrupt financial markets. In the event of market dysfunction, tools built to address the Bank's financial stability objective can be used without constraining the MPC's ability to make monetary policy decisions for QT.

The Bank will continue to develop its understanding of QT as the process progresses. The MPC's next review in September will benefit from another year of data and experience.

The Bank will communicate the findings of this review clearly in due course.

The Annex to this letter responds to all recommendations directed at the Bank in more detail.

I would like to thank you again for the Committee's report and hope this information is helpful.

Yours sincerely,

Andrew Bailey

Annex

Recommendations are referred to by the paragraph numbering conventions in the concluding section of the committee's report.

Evidence on the impact of QT (Recommendations in paragraph 6)

The MPC continues to take the impact of QE and QT into account through its assessment of asset prices and through the scheduled annual review of the QT programme.

While the MPC judges annual reviews to be appropriate in line with the principles outlined above, the quarterly Monetary Policy Reports and the minutes of each MPC meeting contain assessments of asset price developments which incorporate the effects of QT. The Bank is constantly monitoring market liquidity and functioning, drawing on a combination of market intelligence and data analytics, as set out in a number of publications.[15] This monitoring is also mindful of the wider drivers of money and inflation in the economy. The impact of asset purchases on monetary developments is included as part of its regular assessment in Monetary Policy Reports and MPC minutes.

Bank staff have used various modelling and forecasting tools and undertaken a range of quantitative analysis to estimate the impact of QT to date, as detailed in Box A of the August 2023 Monetary Policy Report. The tightening impact of unwind has been, and is expected to be, smaller than the loosening associated with asset purchases: the impact of QE in the past cannot be mechanically applied to measure the impact of QT, simply with the sign reversed. That predominantly reflects the state contingency of the transmission channels, as set out for the asset purchases in the 2022 Q1 Quarterly Bulletin.[16] As such,

15 See https://www.bankofengland.co.uk/speech/2023/july/dave-ramsden-speech-on-quantitative-tightening-chaired-by-money-macro-and-finance-society - speech by Dave Ramsden, Box A in the August 2023 Monetary Policy Report and Bond trading, innovation and evolution: a Bank of England Perspective - speech by Dave Ramsden

16 See https://www.bankofengland.co.uk/quarterly-bulletin/2022/2022-q1/qe-at-the-bank-of-england-a-perspective-on-its-functioning-and-effectiveness

when unwind is conducted in a manner consistent with the key principles the MPC have set out, several transmission channels are expected to be and intended to be smaller or absent.

The empirical evidence so far continues to support prior expectations that the unwind would have some tightening effect on financial conditions, but that this would be small, although there is uncertainty about the precise measures.[17] Given this uncertainty, this continues to be an active area of research both in the Bank and other central banks and in academia and the MPC will continue to learn from it.

Impact of QE, QT and public debt management (recommendations in paragraphs 13, 15 and 22)

The recommendation in paragraph 15 asks for an assessment of individual rounds of QE. The MPC decisions based on monetary policy purposes are taken independently by the MPC, solely to meet the MPC's policy objectives in line with its statutory mandate to achieve the 2% inflation target. In line with these key principles judging the effectiveness of policy decisions, the MPC considered every round of QE appropriate and necessary to meet its mandate and the remit given to it by the government.

QE has formed an important part of the monetary policy toolkit since the Global Financial Crisis. With Bank Rate constrained by a lower bound, the MPC turned to asset purchases as a means for providing additional monetary stimulus an supporting the economy. Asset purchases should therefore be judged on the basis of how successful they have been in supporting the MPC's pursuit of the inflation target.

As outlined in the section above identifying the impact of asset purchases is inherently challenging. However, as discussed in the Bank's Quarterly Bulletin article,[18] the evidence on balance suggests that QE has pushed down on longer-term borrowing costs for households and corporates, which stimulated demand and helped the MPC reach its 2% inflation target.

The MPC explicitly do not take account of the profit and loss of the portfolio of assets purchased when making decisions on monetary policy. The indemnity from HMT allows monetary policymakers to focus how they set the stance of monetary policy to best achieve their mandate of price stability.

That being so, the recommendation in paragraph 13 asks about criteria on 'value for money' in the context of QT. Subject to the MPC's policy objectives, 'value for money' is reflected in the Bank's operations, that are governed, designed and risk managed with the aim of minimising cost and risk. I set these out in more detail in my letter to the Chancellor in April 2023.[19] For instance, the use of auction mechanisms that are carefully designed to maximise demand and competition. This allows us to accept only the best-priced bids across a range of bonds and participants. APF auctions also have built-in price protections and controls.

The recommendation in paragraph 22 sets out that the Bank and HMT should investigate whether it would be possible and appropriate to adopt a deferred asset accounting as an

17 See Box A in the August 2023 Monetary Policy Report and the recent paper by Du, Forbes and Luzzetti (2024).
18 See https://www.bankofengland.co.uk/quarterly-bulletin/2022/2022-q1/qe-at-the-bank-of-england-a-perspective-on-its-functioning-and-effectiveness
19 See https://www.bankofengland.co.uk/-/media/boe/files/letter/2023/governor-apf-letter-april-2023.pdf

alternative to current arrangements. QE/QT operations give rise to a set of cashflows between the APF and HMT. These are flows within the public sector accounts. The UK arrangements have the benefit of being fully transparent. Hence, the Bank has been fully transparent about cashflows to and from the APF and presents a set of projections in the APF Quarterly Reports. Changing the accounting treatment would not alter the underlying public sector impacts of QE or QT. Additionally, a deferred asset approach would not be feasible given that it requires a future income stream to offset any negative cashflows–and a unique feature of the UK arrangements is that all seigniorage income (net of some costs) is paid to HMT. That is one reason why the indemnity exists, in line with the Memorandum of Understanding on the financial relationship between the Treasury and the Bank of England.

Monitoring gilt market sentiment (recommendations in paragraph 9)

The Bank publishes the aggregate gilt market participant demand and results of all of its QT auctions, including offers received for each gilt available for sale, total amount of the auction allocated to each gilt, and details on the pricing for each gilt. This gives a high degree of transparency to the market on the level of demand for the gilts sold from the APF. These results are made available shortly after the end of each auction and are published on the Bank's website.

In addition, the Bank regularly gathers market intelligence in support of the MPC's remit for monetary policy, and regularly surveys a broad set of market participants through the Market Participants Survey (MaPS).[20][21] The results of this survey give some indicators to market expectations across a range of issues, including market participants' expectations for gilt yields.

Arrangements for the future Bank's balance sheet in steady state (recommendations in paragraphs 4 and 20)

The recommendation in paragraph 20 states that the Bank and Treasury should clarify the future arrangements for the steady state level of reserves, including the future of QT at that point. It is important to note at the outset that QT is only one factor behind the normalisation of the Bank's balance sheet. Reserves may also fall for other reasons, most notably repayments of loans made under the Bank's Term Funding Scheme with additional incentives for small medium-sized enterprises (TFSME). Nevertheless, a reduction in the size of the APF has implications for the level of reserves in the system.

In September 2022 the Bank set out its arrangements for allowing the MPC to focus solely on monetary policy considerations in setting its strategy for unwinding its stock of asset purchases.[22] These arrangements are designed such that the MPC could, over time, if it judged this necessary for policy reasons, unwind the APF fully in line with the gradual and predictable approach that it has previously articulated. It does not state that QT would cease at a certain level of reserves, nor would it rule out other choices.[23]

20 See https://www.bankofengland.co.uk/speech/2022/june/andrea-rosen-remarks-at-the-association-for-financial-markets-in-europe-event - speech by Andrea Rosen

21 See, e.g https://www.bankofengland.co.uk/markets/market-intelligence/survey-results/2024/market-participants-survey-results-february-2024

22 See https://www.bankofengland.co.uk/markets/market-notices/2022/august/explanatory-note-on-operational-implications-of-apf-unwind

23 Also see https://www.bankofengland.co.uk/speech/2024/february/david-ramsden-keynote-address-at-association-for-financial-markets-forum - speech by Dave Ramsden

To maintain control over short-term market interest rates during this period and in order to implement monetary policy, the Bank announced a new market operation in the same market notice–the Short Term Repo Facility (STR)–that allows commercial banks to borrow unlimited reserves at Bank Rate against gilt collateral on a weekly basis. In addition, we expect usage of the full set of our liquidity facilities to rise as the level of reserves in the system falls. At the point that reserves reach the minimum desired level, banks will be able to meet their demand for reserves at Bank Rate using the Bank's liquidity facilities, stabilising the quantity of reserves and allowing the MPC to decide to continue reducing the stock of assets held in the APF for monetary policy purposes, should it judge that necessary for monetary policy reasons.

The quantity of reserves needed to maintain monetary control and financial stability once QT has completed and TFSME drawings have been repaid is likely to be substantially higher than in the past. The Bank is continuing to analyse the optimal steady state level of reserves for monetary and financial stability, as discussed in more detail in a recent speech by Andrew Hauser, among others.[24]

In addition to this, the recommendation in paragraph 4 asks the Bank to develop its planning on the long-term steady-state size and composition of the balance sheet. The Bank is currently undertaking work to determine the appropriate long-term mix of assets to hold on its balance sheet. Decisions on the asset mix have implications for the Bank's policy objectives, and risks to the public sector balance sheet. Decisions on the size and shape of our future balance sheet will be made in close consultation with HM Treasury and relevant stakeholders and communicated in a transparent manner.

Backstop tools for financial stability (recommendations in paragraph 8)

The Bank is taking action in line with its statutory duty to protect and enhance the financial stability of the UK financial system. The FPC has also set out the actions it is taking, both domestically and in conjunction with international work, on addressing the risk of severe dysfunction in core sterling markets when there is a threat to UK financial stability.,[25] [26] Front and centre in this strategy was the need for stronger private self-insurance, market infrastructure and liquidity regulation. Primary responsibility for ensuring appropriate resilience to the wide and evolving range of idiosyncratic liquidity risks lies with firms themselves.

This work will support the Bank's readiness to respond to any future market stresses that might arise and threaten financial stability. The Bank's work in this space include facilities to lend to non-bank financial institutions, for the purpose of addressing severe dysfunction in core sterling markets when there is a threat to UK financial stability and existing facilities cannot channel sufficient liquidity to the financial system as a whole.[27] I would note that the Bank is working at pace to launch an initial version of this facility, which would lend cash in exchange for gilts to eligible insurance companies and pension

24 See https://www.bankofengland.co.uk/speech/2023/november/andrew-hauser-keynote-speech-bank-of-england-watchers-conference - speech by Andrew Hauser and Loughborough lecture: Banking today - speech by Andrew Bailey

25 For more discussion of these issues, see https://www.bankofengland.co.uk/financial-stability-in-focus/2023/october-2023

26 For more information, see Section 1 of The Financial Policy Committee's medium-term priorities (2023–2026) Bank of England

27 https://www.bankofengland.co.uk/speech/2024/march/nick-butt-keynote-speech-at-isda-virtual-conference-procyclicality-and-margin-practices

funds (ICPFs), including associated LDI funds. Nevertheless, there may be instances where a lending facility alone is not sufficient to address market dysfunction. Alongside the work to develop the new lending facility, the Bank is working to learn lessons from the September 2022 intervention.

Carrying out operations in the gilt market is a core function of the Bank that contributes towards delivering on its monetary and financial stability objectives. However, operations designed to fulfil financial stability objectives, such as those during October 2022, are different in nature to QE or QT which are conducted for monetary policy purposes and in line with the remit received by the MPC from the government.

With regard to the MPC's strategy for QT, the Committee agreed that there would be a high bar for amending the planned reduction in the stock of purchased gilts outside a scheduled annual review. That was in order to remain consistent with the design principles of QT in that gilt sales should be gradual, predictable and not disrupt financial markets. In the event of market dysfunction, tools built to address the Bank's financial stability objective can be used without constraining the MPC's ability to make monetary policy decisions for QT.

Appendix 3: Debt Management Office

Letter from the Debt Management Office

Dear Harriett,

I am writing to you in response to the report published on 7 February 2024 by the Treasury Committee, which investigated various aspects of quantitative tightening (QT), including its impact on the economy and financial stability and its fiscal consequences. This letter sets out a response to the following recommendation, which is relevant to the Debt Management Office (DMO). The Bank of England will respond separately to this recommendation:

"Given the unusually high extent of gilt sales in the coming years, the Bank and the Debt Management Office should publish more frequent updates on gilt market participant demand and sentiment."

As a starting point, I would like to say how welcome it is that the Committee has given careful consideration to the coming years and the potential challenges facing our work at the DMO. In responding to your recommendation, I would like to draw a distinction between demand and sentiment as I believe different considerations are relevant in the event of official updates on those topics.

In relation to participant demand, we take a twofold approach. First, and very much to your point, we consider it absolutely fundamental to the good functioning of the market that official operations (primarily our gilt auctions) should be 'public' events that allow the market to see and understand the demand and supply dynamics applying at the point at which each auction takes place. After all, notwithstanding the good and ready availability of price data in today's markets, our auctions will tend to occasion some of the larger flows in the market and, therefore, have particular salience. For that reason, following each of our auctions, we publish results statistics which are carefully designed to share with the market the information relevant to understand demand conditions at the aggregate level, while duly preserving the confidentiality of participant bidding, which is essential given auctions are a competitive market mechanism.

Second, we fully concur that it is important that we, and the government more broadly, should publish material regularly about the factors–including demand–that inform decisions about the design of the financing programme.

I would like to emphasise that the DMO's financing remit is designed and implemented in pursuit of the Government's debt management policy objective, which focuses on minimising, over the long term, the costs of meeting the government's financing needs, taking into account risk. The debt management objective is achieved, in part, by meeting the principles of openness, transparency and predictability. This allows the financing programme to be set out for the year ahead and implemented in a programmatic way: by ensuring the market's demand dynamics will be fully informed about the impending supply profile, there is no need for the market to levy an unpredictability risk premium on government (e.g. by 'charging' a higher yield in response to unpredictable supply patterns).

In accordance with these principles, and particularly in relation to the principle of transparency, the DMO currently publishes regularly a range of reports and data that serve to update stakeholders on matters relating to gilt market demand and the financing remit. I have set these out in the annex to this letter.

However, and turning now to the subject of sentiment, the DMO deliberately does not publish its own views on market sentiment, although we report regularly, in summary form, opinions provided by market stakeholders concerning demand and market conditions (please see the annex). The reason for not publishing DMO opinions about market sentiment is because we believe doing so could be counterproductive, given that the DMO is a major official sector participant in the gilt market and, as such, there is a material risk that any opinions expressed by the DMO could themselves impact market sentiment and/or jeopardise our achievement of the debt management task in a potentially negative way. For example, if we were to publish a concern that market sentiment was unpropitious, the market might read into this that we would be more tolerant of accepting very low prices at an auction and adjust their bids accordingly.

Furthermore, consistent with the programmatic approach outlined above, it is the DMO's role essentially to act as a price taker in the gilt market, which also accords with the absence of any mandate to attempt to set or influence prices or yields. In that context, we would not want to introduce the possibility that we might inadvertently influence, or be seen to be attempting to influence, market behaviour (including prices and/or yields) as a result of publishing opinions about market sentiment.

In conclusion, I would like to thank the Committee for making its recommendation on the frequency at which information is published by the authorities about gilt market demand and sentiment in the context of projected high gilt sales in coming years. This context makes it more important than ever to ensure that the DMO's engagement with the gilt market encourages a well-functioning market in which prices continue to adjust smoothly to absorb the amount of stock on offer at our gilt sales operations. Whilst it does not provide a guarantee, I do believe that the open, predictable and transparent approach we take to sharing data and information with the market as summarised above (and set out in more detail in the annex) will continue to help ensure our financing remit is delivered as smoothly as possible.

I very much hope this information is helpful and please do not hesitate to contact me again if you have any further questions.

Yours sincerely,

Robert Stheeman

Chief Executive Officer

Annex

The DMO focuses on being as open and transparent as possible about the structure of the financing remit and the rationale for it, and reporting in-year in a timely way on progress with remit delivery, particularly the results and performance of each of our operations. We believe this is the most useful contribution the DMO can make to ensuring a sound

understanding of the financing programme (including progress towards remit delivery in-year) and providing market stakeholders with as much certainty as possible about our plans, in support of a stable and well-functioning gilt market.

Below is a list of the key outputs currently published by the DMO that we believe help to provide a comprehensive and timely picture to external stakeholders about demand for gilts and market conditions. The frequency with which information is published varies significantly, reflecting a number of factors, including the frequency at which gilt sales operations are scheduled, the timetable for setting the DMO's financing remit and the frequency and timeliness with which related data are published.

1. The DMO's annual financing remit

The annual Debt Management Report (published by HM Treasury alongside the Budget[28]) provides the context for the government's decisions on gilt and Treasury bill issuance each year, setting out the qualitative and quantitative considerations that have influenced them. The purpose is to set out the rationale for our decisions on the financing remit with a view to providing market stakeholders with a more comprehensive understanding of the DMO's and the government's 'reaction function' in debt management.

We believe this contributes to stability by building a better understanding over time amongst stakeholders about how the DMO will be likely to react to any given set of circumstances, thereby reducing uncertainty in accordance with the predictable approach to debt management. Unless there are significant changes during the financial year to demand and market conditions, the overall structure of the remit will be set only once prior to the start of the financial year. Hence, it is generally appropriate to publish this information only annually.

2. Minutes of consultation meetings held annually and quarterly with GEMMs and gilt investors

As you will be aware, meetings chaired by the Economic Secretary to the Treasury are held annually with Gilt-edged Market Makers (GEMMs) and representatives of gilt investors at which market feedback is sought on the overall approach that should be taken by HM Treasury/the DMO to the design of the financing remit for the forthcoming year, informed by views on anticipated demand and market conditions. Meetings are also held quarterly at the DMO with GEMMs and gilt investors at which feedback is sought on the details of the operations calendar for the forthcoming quarter. In all cases, the DMO publishes summary unattributed minutes at 8am on the day after each meeting, which summarise the main points that arise from these discussions. The intention in so doing is to provide all interested parties simultaneously with timely information about market views on: (i) demand prospects in the forthcoming year and likely conditions in which the remit will be delivered (annual meetings); and (ii) the specific gilts that should be issued in the forthcoming quarter, together with any context about changing demand or market conditions if relevant (quarterly meetings). We believe that the frequency at which these minutes are published is appropriate to the annual/quarterly timetables for decision making about the financing remit and its implementation in-year.

28 The Debt Management Report 2024–25 can be accessed at: https://www.dmo.gov.uk/media/4kihuxsy/drmr2425.pdf

3. Auction and syndication results and performance metrics

Following the conclusion of each gilt auction, the DMO publishes within 15 minutes a press notice summarising the auction result. These press notices include the following factual information, which provides an indication of the relative strength of the auction, thereby giving some insight into market conditions at auction close:

- *auction cover ratio*: the ratio of the total amount of bids received to the amount on offer at a gilt auction; and
- *auction tail* (for auctions of conventional gilts only), which is the difference between the yield at the average accepted price and the yield at the lowest accepted price at an auction, expressed in basis points. This metric provides an indication of how concentrated bidding is around the market level, which is indicative of the strength of demand for the gilt on offer.

Following the conclusion of each syndication, the DMO publishes on the day of the transaction a press notice summarising the syndication result. These press notices include:

- *factual information about the performance of the transaction*, including the price and yield achieved, the number and total volume of orders and the percentage of the issue that was allocated to domestic market participants; and
- *a comment from a DMO source on the result of each syndication*, briefly evaluating the delivery of the transaction and the level of support received from investors.

4. Regular publications on the DMO's website related to gilt demand and market conditions

Our website provides access to a range of other relevant publications and data, including:

- *An Annual Review* of the DMO's activities in the previous financial year, including macroeconomic and gilt market developments, the monetary policy background to the delivery of the financing remit and the evolution of the financing remit during the financial year. Although necessarily retrospective, the Annual Review does set out for stakeholders the economic and market context in which the remit was delivered and the way in which it has been revised in response particularly to updated fiscal forecasts.
- *A Quarterly Review*, setting out a range of data related to the gilt market, including portfolio statistics, developments in yield curves, indicators of gilt market activity such as gilt market turnover and a breakdown of gilt holdings by investor type.
- *Time series data* on a range of variables related to debt management including: (i) detailed turnover statistics showing the volume of gilts traded in the market over time, broken down by type of counterparty and also by maturity; (ii) debt portfolio statistics showing the breakdown of the portfolio by maturity and type of gilt. These data reflect the evolution of underlying gilt demand over time (for example showing how, historically, the proportion of long conventional gilt

issuance rose over time, reflecting the strength of demand for long gilts); and (iii) distribution of aggregate gilt holdings, a breakdown of government holdings for each gilt in issue and how these have evolved over time.