The Bank of England's Monetary Policy

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As the second oldest and perhaps the most renowned central bank, the Bank of England could provide some important insights into issues that may confront the Federal Reserve System in the future. The next section provides a brief review of the Bank's history, while the second section discusses its current procedures. A brief conclusion follows.

A Brief History of the Bank of England

The Bank of England was chartered as a joint stock company in 1694 in return for a loan of £1.2 million to the government. In addition to its commercial activities, it was expected to handle the government's accounts and to assist with its funding. Although the Bank immediately began issuing notes, not until 1709 did it achieve a virtual monopoly in note issuance. Eventually, the Bank both provided settlement services between banks and assumed responsibility for the stability of the banking system as a whole by acting as the lender of last resort.

At the beginning of the nineteenth century, a rise in gold prices sparked a serious debate over the Bank's purpose. Participants were divided into two camps: the currency school and the banking school. The currency school argued that for currency stabilization, currency issuance should be strictly tied to gold deposits. The banking school countered that monetary and macro stability depended on all of the Bank's liabilities, not just notes. Vestiges of this debate can still be seen in the accounting structure of the Bank; by the Bank Charter Act of 1844, the Bank was, and still is, separated into two departments with their own balance sheets. The role of the note issuance department was to ensure that the currency was fully backed, while the banking department was expected to carry on as a normal commercial bank, with its own separate balance sheet. Thus, given the responsibilities of the Bank at the time, its assets consisted of specie, government debt, and bank bills.

De facto, the spirit of the Act was repealed almost immediately. A consensus soon arose that consideration of all the Bank's liabilities, not just notes, was important to achieve its larger goals of convertibility, under the gold standard, and macro stabilization. Furthermore, concerns arose that the Central Bank's role as a commercial bank could interfere with the attainment of its macro goals.[1] From the moment the 1844 Act was passed, the Bank was pressured to unify its two departments and minimize its commercial functions. Although the two departments have never officially been unified, toward the end of the nineteenth century, the Bank's commercial function was limited.[2] But, it was not until the 1920s that the Bank finally eschewed commercial business. Since then, the Bank's actions have been determined by its macro goals.

Of course, when the government ran large deficits, the Bank's objective of a stable currency came into conflict with its obligations to assist with the government's funding. The Bank often resolved that conflict by temporarily suspending convertibility, as it did during the Napoleonic Wars and the world wars.

Britain went off the Gold Standard in 1931, and the mission of the Bank was altered. Under the Bank of England Act of 1946, complete ownership of the Bank passed to the government. The goals of the central bank again changed. Convertibility, however, still played an important role, as Bretton Woods forced the government to conduct policy consistent with a fixed dollar / pound exchange rate. Yet, the goal of maintaining full employment now moved into the foreground. To help attain these multiple goals, the Bank relied heavily on quantity controls on the creation of credit.[3] When the two goals appeared to be hopelessly in conflict, the exchange rate was altered.

Movements toward central bank independence eventually led to the 1998 Bank of England Act. The Act gave the Bank freedom in setting the monetary instrument, the interest rate. However, the Act also codified the Bank's goals. The government set an inflation target for the Bank of around 2 percent and required the Bank to "support the government's economic policy." As a byproduct of this new instrument independence, government debt management was moved from the Bank to the Treasury.

The Current Procedures

Open Market Operations—How?

Although giving the Bank of England instrument independence was a significant change, the instrument itself has remained relatively constant over time. The Bank currently targets the interest rate at a maturity of about 14 days. The mechanism it uses to attain this target is quite simple. Since reserve requirements are essentially nonexistent,[4] and all accounts must settle at the end of each day, the Bank of England creates a shortage of reserves in the market so that the system as a whole must come to the Bank for liquidity. The Bank merely sets the rate at which it provides this liquidity to the market.

The Bank of England intervenes in the market several times daily. In the morning, the Bank informs its counterparties of its estimate of the size of the day's shortfall in liquidity.[5] At this point, the Bank states its willingness to buy securities equal in value to that amount at the target interest rate. The bank then receives offers for quantities from its interested counterparties. All eligible counterparties and all eligible assets are welcome.[6] If demand for liquidity is higher than the Bank had anticipated, it prorates the bids across the different counterparties according to the size of their bids and the different assets offered. The Bank usually repeats this exercise one or two more times during the day as it reestimates the shortfall. Of course, if there is a surplus of liquidity at the beginning of the day, the Bank drains liquidity via reverse repo (from the market's perspective) using DBV (delivery by value) gilts.

[1] Fears became more acute that commercial self-interest, specifically the Bank's competition with other banks, might interfere with both its macro role and its role as the lender of last resort.

[2] The Bank was treated like a public utility. The shareholders were given a fixed return, no matter how the commercial part of the Bank performed.

[3] The use of controls faded after the collapse of the Bretton Woods system, although the "corset" was temporarily installed in the mid- to late 1970s.

[4] The Bank can call for "Special Deposits" if needed, but that instrument has not been used since 1979.

[5] The counterparties were historically the big discount houses involved in settlement, but the number of eligible institutions increased in the 1990s to ensure a more diverse distribution of the liquidity.

[6] Occasionally the Bank will state a preference for a certain security at the initial invitation.

By 4:20 p.m., a late overnight repo facility, which may be charged at a penalty rate, addresses any remaining liquidity shortage. Note that the Bank does not have a Lombard / discount window that banks can access at their discretion.

Open Market Operations—What?

Before the mid-1990s, open-market operations were almost exclusively conducted as outright purchases or sales of securities. The repo market was too small to conduct monetary policy. From the beginning, the assets accepted by the Bank of England in these transactions were very short-term Treasuries, local authority bills, and bank bills backed by a self-liquidating transaction (“real bills”). At least in the twentieth century, Treasuries were a major share of these assets. The exact role of bank bills and specie in the eighteenth and nineteenth centuries would be interesting to study if the data were more readily available. Note that gilts, the longer-term government securities, were not, as a rule, purchased.

In the early 1990s, concerns arose that the short-term paper market, particularly Treasuries, was not growing quickly enough to satisfy the needs of the financial system. The first row of Table 1 highlights the extent of this problem, as the Bank’s share of the market in its usable assets reached 13 percent by 1990.

The Bank of England responded by expanding the acceptable asset pool in several steps. First, the value of eligible assets increased significantly in March 1997 when the repo market became sufficiently deep to allow open-market operations in these assets. In fact, repos, usually backed by long-term gilts and averaging about 14 days in maturity, have become the most frequent security used by the Bank; outright purchases now represent a far smaller percentage of current operations.

Second, beginning in October 1998, some sterling-denominated foreign government and major international institution debt, issued in the United Kingdom (CREST), the “bulldogs,” were accepted as collateral. As Table 1 shows, this had a minimal effect on the collateral base.

Third, in June of 1999, the collateral pool was further expanded to include sterling-denominated bonds of European government and international agencies that were accepted in Euroclear / Cedel, and similar euro-denominated securities eligible in European Central Bank (ECB) monetary policy operations. In August of 1999, euro-denominated debt of European governments and central banks, where the central bank in the foreign country acts as the Bank’s custodian under the Correspondent Central Bank Model and where the assets are eligible for open market operations for the ECB, were added to the list of assets acceptable as collateral. These last assets account for most of the £2 trillion increase in the asset base in 1999.

Finally, in March of 2000, restrictions on the bank bills accepted were liberalized. Traditionally, the Bank only accepted bank bills backed by a self-liquidating transaction (“real bills”). Acceptable short-term bills now can be backed solely by the general creditworthiness of the borrower.

The recent expansion of acceptable assets could also have been motivated by concerns other than shallowness in the market. Although the debt-to-GDP ratio in the United Kingdom remains around levels comparable to those in the United States, it is not projected to decline at the pace forecasted in this country.[7] Instead, changes in the financial institutions in Europe forced their competitors in London, that is, the Bank of England’s counterparties, to deal in assets more consistent with the euro area as a whole.

Table 1
Collateral Eligible in Open-Market Operations

End of Year	Billions of pounds	Percent held by Bank of England
1990	37	13
1995	30	11
1996	34	14
1997	320	2
1998	327	3
1999	2,325	1

Source: Reprinted from “Sterling Wholesale Markets: Developments in 1999,” *Bank of England Quarterly Bulletin*, February 2000.

Open Market Operations—Asymmetries

The assets the Bank accepts as collateral differ from those it accepts for outright purchase. The securities offered for outright sale to the Bank must

[7] In fact, at the Bank of England’s 1998 conference on “Government Debt Structure and Monetary Conditions,” staff raised traditional concerns of too much public debt forcing monetization; they did not address the repercussions from a shortfall of public sector debt.

be sterling-denominated, which rules out the euro-denominated foreign debt accepted as collateral for repos.[8] Furthermore, the debt must be of a maturity called for in the invited bids; it cannot have a maturity longer than the longest invited repo. The maturity represents an asymmetry because the repos can be backed by long-term collateral, but no outright purchase of this collateral is allowed.

One possible reason for these two restrictions could be risk minimization. A repo has a known resale value as of the time of its purchase. The value of the other securities can fluctuate, even if they are held only briefly. The Bank wants the repo seller to bear any foreign exchange or interest rate risk on the foreign-denominated or long-term asset. The motivation for this degree of risk minimization is, however, uncertain. Finally, there are no preset rules for collateral for loans emanating from the Bank's function of lender of last resort.

Conclusion

The Bank of England is not worried about a shortfall of collateral. In the early 1990s, the Bank's emphasis on short-term securities caused some concern about asset availability. The United Kingdom solved this apparent problem by opening up a repo market with long-term gilts and euro-asset collateral that was significantly more far-ranging than the outright purchases the Bank makes. How much of the expansion in assets was needed because of the shortfall in Treasuries and bank bills, and how much was politically motivated by the possible goal of future entry into the euro area or a desire to maintain London as a financial center in Europe, is unclear.

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[8] The foreign exchange stabilization fund was moved to the Treasury with the Bank of England Act of 1998, so the Bank currently owns some exchange assets. These are mostly euro-settlement balances, with some dollar swaps.