Minouche Shafik: Goodbye ambiguity, hello clarity – the Bank of England's relationship with financial markets

Speech by Ms Minouche Shafik, Deputy Governor for Markets and Banking of the Bank of England, at the University of Warwick, Coventry, 26 February 2015.

* * *

1. Introduction

I'd like to talk to you this evening about the Bank of England's relationship with financial markets. In particular: how we use our balance sheet and how we gather market intelligence. I appreciate my saying that may immediately make you regret giving up your Thursday evening to hear a central banker speak! But let me make the case that the central bank's balance sheet and the way we understand financial markets is at the very heart of modern policy making. And let me also argue that the journey from "constructive ambiguity" toward greater clarity around how we interact with markets is essential for the effectiveness of a modern central bank.

The Bank of England's balance sheet is the means by which we create money and hence the source of our monetary policy responsibilities. It is the vehicle through which we provide liquidity insurance to the financial system, a crucial part of our financial stability objective. And it is the point at which the implementation of macro policies meets the micro-reality of interactions with individual institutions. In all of these the Bank has proven agile in its ability to respond to the financial crisis and the changes in its responsibilities.

Just as importantly, our interactions with markets give us a window through which to gather information about developments in financial markets. We refer to this as Market Intelligence (or MI). The purpose of MI is to ensure that the Bank's policy decisions are made and implemented with a detailed understanding of the financial market context in which the Bank operates. The way we go about MI is changing – as set out in a Review we have published today – and I will take the opportunity to talk you through what I see as the key points.

A recurring theme throughout these remarks is that the days when "constructive ambiguity" was seen as a helpful foil for central bankers are behind us. In today's complex and globalised financial system, Governors' eyebrows and fireside chats are no match for a clearly communicated framework in which information will be gathered and decisions made.

2. The way we were: a brief history of money & liquidity provision

Let me begin with a little historical perspective. The Bank of England was founded in 1694 during a time of war with France and was tasked with arranging a £1.2 million loan to the government. This was funded by members of the general public, and "Dividend Day," when payouts were made to the public, is still immortalised in a painting that hangs in the Bank today.

At the time, there was excitement about the idea that a stable banking system could be a source of liquidity to fund the expansion of the economy. So in addition to being the government's banker, the Bank also engaged in commercial activities: taking deposits in exchange for which it issued notes – and providing loans by discounting commercial bills.

That was 321 years ago. The Bank of England you see today has its roots in a relatively more recent act of Parliament. I refer of course to the 1844 Bank Charter Act, which paved the way for the Bank to become the monopoly supplier of bank notes, and effectively responsible for monetary policy in the UK. The Act also had the effect of limiting the amount of commercial business the Bank could undertake, so it chose to concentrate not on competing with the emerging joint-stock and clearing banks, but instead to focus on its role as banker to the banks, and supplier of liquidity of last resort. It could be argued that this was the point at which the Bank's financial stability role was born.

In subsequent years, as the Bank sought to define this role, it was helped by the advice of Walter Bagehot, a keen student – and sometime critic – of the Bank of England's reaction to banking crises over history. By 1873 Bagehot had seen enough to declare that the correct policy for the Bank to pursue in order to head off an incipient panic would be to lend "freely and vigorously…on all good banking securities", but to do so only "at a very high rate of interest...that no one may borrow out of idle precaution."[1]

Bagehot had two other pieces of advice for the Bank that are relevant today. First, he advised that there should be a "clear understanding between the Bank and the Public that, since the Bank holds [the] ultimate banking reserve [it] will recognise and act on its obligations". Second he advised that the Deputy Governor must be "a man of fair position" who "must not have to say 'Sir' to the Governor". This is a slightly old-fashioned way of saying that the Deputy Governor should be independent minded, that the Bank should empower its staff and must always remain credible with the public. (Even though Bagehot foresaw many things, even his liberal mind hadn't foreseen the day when the Bank would have more than one Deputy Governor, and among them a woman!)

3. A balance sheet that has evolved to meet the needs of monetary policy

From a £1.2 million loan to the government in 1694, the Bank's balance sheet has grown a long way to its current size of £400 billion. As Figure 1 shows, most of that expansion has come in the past 7 years, in large part reflecting the implementation of monetary policy since the financial crisis that started in 2008. Maintaining credibility in the money we issue has been an objective of the Bank from inception. Since the early 1990s this has been pursued through an inflation targeting regime, and most of that period the tool of choice for monetary policy was interest rates.

In the wake of the financial crisis and ensuing recession, however, Bank Rate was cut to a historic low of 0.5% – a level that was at the time considered to be the effective lower bound as further cuts could reduce the profitability of the banking sector and constrain the supply of credit to the economy. When more stimulus was needed, the MPC used a different tool – the Asset Purchase Facility – to deliver the needed stimulus by expanding the balance sheet using newly created central bank reserves to purchase £375 billion of government bonds with a range of maturities out to 55 years.

Of course what was once considered radical has become mainstream by today's standards. Indeed other central banks have gone further as the circumstances of their economies have dictated. The European Central Bank and the Bank of Japan have stated their intention to purchase significant amounts of private sector assets, and some central banks have used their balance sheets to purchase other countries' assets with the aim of maintaining their exchange rate at a certain level.

The key point is that even though interest rates had been the marginal tool of monetary policy for several decades, monetary policymakers never forgot that this was only one manifestation of the central bank's unique ability to create narrow money. And when the effective lower bound was reached, stimulus could continue to be provided by expanding central banks' balance sheets in new ways.

Someone recently said to me that Quantitative Easing (QE) is "like magic," as if central bankers are sorcerers with the capacity to conjure up economic miracles. I wish. In fact QE works through the more prosaic channels of reducing longer-term interest rates in the

[1] Bagehot (1873).

economy, and encouraging private sector investment in riskier assets by reducing the supply of long-duration government bonds, a phenomenon we call portfolio rebalancing.

But the underlying point that the effect of this new monetary policy tool is less intuitively understood is well taken. That makes effective communication and accountability important to monetary policy and indeed all central bank policies. These points were made very clear by Kevin Warsh's recent review of transparency and the MPC. As a result, this August the MPC will begin publishing the minutes of its policy meetings and the Inflation Report at the same time as its policy decisions, giving markets and the public a clearer understanding of what underlies the judgements we make.

Looking forward, it seems to me that the most likely next move in monetary policy will be a gradual and limited increase in interest rates. The current weakness in headline inflation largely reflects transitory – albeit sizeable – factors such a close to 50% decline in the price of oil, and the appreciation of sterling over the past two years. The underlying picture is one in which domestic demand is expected to continue growing robustly, facilitating a pick-up in wage growth, which we are starting to see, and a return of inflation to target.

But we don't have a crystal ball, and should circumstances turn out differently, the MPC has the means, the will and the responsibility to return inflation to 2%. On the upside, should the remaining slack in the economy be absorbed more quickly than expected, the MPC can increase rates more quickly than currently implied by market yields.

On the downside, should we perceive that low inflation is beginning to have a self-reinforcing effect through inflation expectations, we will have several tools at our disposal. One would be to increase rates more slowly than currently implied by market yields. Another would be to expand the Asset Purchase Facility and with it the Bank's balance sheet. Another would be to cut Bank Rate further: the banking system is now operating with substantially more capital than it did in the immediate aftermath of the crisis. So reductions in Bank Rate are less likely to have undesirable effects on the supply of credit the UK economy than previously judged by the MPC.

Some day we will also need to exit QE (though that will not come at least until Bank Rate has reached a level from which it could be materially cut were more stimulus required). Such a decision will be taken in pursuit of our inflation target. But I can assure you that this will be done in an orderly and clearly communicated fashion to avoid undue disruption in financial markets, including through close coordination with the Debt Management Office.

4. Expanding and clarifying liquidity insurance

How we use the balance sheet also needed to evolve to meet our financial stability objectives over the course of the financial crisis. In the decades prior to the crisis, the need for the Bank to provide liquidity support was infrequent and usually on a small scale.[2] As such, in 2007 the Bank had a relatively limited list of institutions that had access to its balance sheet through what is called the Sterling Monetary Framework (SMF), along with a conservative list of collateral acceptable in its published facilities. And there was little clarity about the circumstances under which the Bank would extend liquidity support for financial stability purposes.

Despite this less-than-ideal starting position, the Bank ultimately embraced the provision of liquidity to the system over the course of the crisis, with the expressed aim of reducing the costs of disruption to critical financial services. This came about via an alphabet soup of schemes, including DWF, ECTR, ELTR, FLS, ILTR, and SLS.[3] Common to all was a

---

2 See Plenderleith (2012) for details of episodes of lender of last resort since 1973.

3 More information about these schemes is available on the Bank's website: http://www.bankofengland.co.uk.

recognition that to achieve its aim, the Bank needed to provide liquidity against a wider range of collateral, to a wider range of counterparties, for a longer term.

Two other innovations are noteworthy.

- First, in some circumstances the Bank lent in a currency other than sterling – a first for our liquidity insurance operations.[4]
- Second, the Bank acted as a market maker of last resort in the sterling corporate funding markets – making small targeted purchases and sales of commercial paper and corporate bonds.[5]

Many of these changes were made in the heat of the crisis. And since the 2012 Winters and Plenderleith Reviews[6] much effort has been exerted in hardwiring them into our operating framework to make it clear to market participants how we would act in future. As Figure 2 shows, the membership of the Bank's Sterling Monetary Framework has increased from 70 in 2007 to 139 and counting. And the collateral we will accept in our regular operations now extends from AAA bonds all the way to own name raw loans. Changes such as these provided the basis for Governor Mark Carney's declaration that the Bank of England is "open for business."

I think changes made since 2007 indicate that we are also "open about our business." The Winters Report highlighted that ambiguity around the Bank's published liquidity insurance framework is rarely constructive. And the Bank is committed to providing clarity around the circumstances under which it would provide liquidity in the event of market-wide or large idiosyncratic stress:

- The Bank's ***Red Book***[7] clearly sets out the aims and objectives of the Sterling Monetary Framework with regard to the provision of liquidity insurance.
- Each SMF participant has a "relationship manager" and we aim to give them clarity about the circumstances in which they can expect to borrow.
- We have improved our external accountability by producing an Annual Report overseen by the Bank's Court which assesses how the framework has performed relative to its objectives.

But hardwiring the lessons learned from the last crisis into our operations will not necessarily provide the agility to provide the liquidity insurance that may be required in the future. For that reason, our approach to liquidity insurance continues to evolve:

- In November 2014 we extended eligibility for membership of the Sterling Monetary Framework to include broker-dealers and Central Clearing Counterparties (CCPs), giving non-banks access to our permanent liquidity insurance facilities for the first time.
- The range of acceptable collateral continues to extend: we have started to approve pools of auto loans and invoice finance receivables as eligible collateral for the first time. And we have started work to ensure there are no technical obstacles to our ability to accept equities as collateral should the need arise.

---

4 The Bank introduced US Dollar repo operations in September 2008, and their usage peaked at the equivalent of $86bn in October 2008. The Bank also provided a peak of US$25bn to RBS via Emergency Liquidity Assistance.

5 The Bank's commercial paper purchase schemes opened in February 2009 with a peak usage of £2.4bn. The corporate bond purchase scheme opened in March 2009, with a peak usage of £1.62bn.

6 Plenderleith (2012) and Winters (2012).

7 http://www.bankofengland.co.uk/markets/Pages/sterlingoperations/redbook.aspx.

- The Bank will commence work in the second half of 2015 to assess the feasibility of establishing a Shari'ah compliant facility. By providing an additional highly liquid asset for Islamic banks, such a facility would be a significant step forward in their liquidity management capabilities.
- We are continuing to develop our capacity to lend in currencies other than sterling.

Although we are providing clarity around how the central bank would react in the event of market-wide or large idiosyncratic stress, it is important that some of our facilities retain elements of discretion. For example, the benefits of Discount Window Facility and Emergency Liquidity Assistance could be undermined by immediate disclosure, if speculation about individual firms were to threaten financial stability. In this respect, both the Winters and the Plenderleith reports recognised that a lag between usage and public disclosure can provide a good balance between our financial stability objectives and our duty to be accountable to the public.

5. Co-ordinating liquidity support with micro-prudential policy

Historically, one of the arguments for having ambiguity over the Bank's provision of liquidity insurance, particularly against a wide range of collateral, was that clarity would induce moral hazard. The more certain banks could be of the availability of liquidity insurance, the less incentive they would have to manage their own liquidity prudently through private markets.

Acting as a mitigant against this, the expansion of the Bank's liquidity provision capabilities has gone hand in hand with two other key developments: the introduction of stronger liquidity regulation requiring banks to hold more liquid assets (Figure 3),[8] and the creation of a resolution regime which makes it more credible that firms will be allowed to fail in an orderly manner.

Taken together, liquidity insurance, the resolution regime and microprudential supervision provide a framework of incentives for banks to manage their liquidity. And their co-existence within the Bank of England makes co-ordination of these policies substantially more straightforward.

Having supervisors close at hand can also help in the decisions around the provision of lender of last resort facilities. In such a situation, a central bank should not lend to an institution which is insolvent. This means that the Bank will need to make a judgement as to whether or not the entity it is lending to has a viable medium term future, or that the Bank has a credible exit strategy.

In practice, distinguishing between illiquidity and insolvency can be difficult. A close understanding of a firm is invaluable in providing the information needed to judge the long term viability of its business model, and in providing short term assessments of its liquidity position. Supervisors are well placed to provide such information and their knowledge of institutions, coupled with our risk managers' assessment of the collateral made available, greatly enhances our ability to make these judgements.

The free flow of such information is of course possible when there is an institutional separation between supervision and the lender of last resort. But my early experience is that having them under one roof greatly enhances our ability to co-ordinate and optimise policy in the public interest.

---

[8] Initially in the form of strengthened FSA liquidity requirements, subsequently the implementation of the Basel III Liquidity Coverage Ratio, which will in turn be supplemented by the Net Stable Funding Ratio.

6. Gathering market intelligence in a more complex and transparent world

Given its responsibilities for monetary policy, macro-prudential regulation and micro-prudential supervision, it is quite rightly expected that the Bank's policy decisions are taken with a detailed understanding of the financial market context in which the Bank operates. Since its inception, the Bank's market operations have long provided a key input to this understanding, by providing first-hand information from financial institutions.

Between the years 1786 and 1989, this was epitomised by the "Senior Broker to the Commissioners for the Reduction of the National Debt." Clad in a top hat, and invariably with a tightly rolled umbrella (see Figure 4 for an example), the holder of that position was responsible for announcing (in person) changes in the Bank's minimum lending rate, and at the same time gathering opinion on the state of the gilt market.

He was expected to report to the Gilt Edged Division three times a day, providing information about market activity, the quantity of buying and selling, and the gilt maturities and coupons that were in particular demand. He was also responsible for reporting on the mood of investors and advised the Bank on the appetite for stock, institutional cash positions and expectations.[9, 10]

Even if top hats are a thing of the past, the essence of Market Intelligence (MI) gathering remains the same today: our staff maintain a regular dialogue with financial market participants to draw on their expert knowledge and perspective of the markets in which they operate. This takes place through bilateral meetings, group discussions, and phone calls, supplemented by all of the screens and data analysis on our modern trading floor.

But compared to the time of the "Senior Broker", the coverage of Market Intelligence has expanded dramatically. The markets in which the Bank operates (i.e. short term money, fixed income and currency markets) continue to provide the natural starting point for our Market Intelligence. But in recognition of the fact that threats to the Bank's ability to achieve its core purposes can have their origins anywhere, coverage has now expanded to 23 different markets as far afield as structured products and emerging markets, covered by 80 analysts across the Bank for whom MI is a significant part of their job.

This first-hand information differs from what can be gathered from our Bloomberg screens, analyst reports, and research – and it provides an important perspective on both short-term moves and long-term trends. It permeates every part of the organisation: every morning the Governors get together to receive an in depth briefing on financial markets from Chris Salmon, the Executive Director for Markets, and part of my job is to brief the MPC on recent market developments and its implications for monetary policy.

MI also feeds into more strategic issues and the policy decisions of the Committees. For example, the delicate decision of how the MPC should communicate its opinion that the effective lower bound for Bank Rate has declined was in part informed by the opinion of our money market desk who were able to tell the MPC what the existing assumptions were in the market.

And I expect market intelligence to make a strong contribution to the FPC's pursuit of its medium term priority of ensuring the existence of diverse and resilient sources of market based finance. Recent episodes (such as a sharp decline and reversal in US Treasury yields in October, a close to 50% decline in the price of oil and the removal of the Swiss Franc peg) have reminded us that volatility in financial markets has certainly not been consigned to

9 As described in Wormell (1985).

10 Also known as "the Government Broker", the Senior Broker to the Commissioners for the Reduction of the National Debt was by convention a senior partner of Mullens & Co, a firm of stockbrokers, until 1986 when the job formally moved into the Bank of England.

history. A key question for both the FPC and the PRA Board will be whether markets' ability to recover reflects their resilience to shocks; or conversely whether these incidents are symptomatic of an underlying fragility. Market Intelligence can play a key role in answering that question.

But the expanded responsibilities of the Bank have also revealed that elements of our approach need to be strengthened. In particular, a recent report by Lord Grabiner indicated concern that the Bank's systems and controls have not always kept pace with the changing role of the Bank.

Today we are publishing the results of a thorough Review[11] of our MI function. From it I would highlight three key points that will remove some unconstructive ambiguities around the gathering of MI:

- First the Bank has published a "Market Intelligence Charter" which explains in clear language the terms of the Bank's engagement with market participants, and its rationale for gathering MI.
- Second the Bank is strengthening the set of policies (including escalation, recording and compliance policies) that govern MI, and expanding the training accompanying those policies.
- Third, the Bank will establish a Bankwide executive level committee to oversee and agree the priorities for the Bank's MI programme to ensure it retains flexibility, focus, and relevance to the policy challenges of today and tomorrow. In addition, a dedicated MI Division will co-ordinate, synthesise and disseminate MI around the bank.

The ability of the Bank's MI function to provide information to senior policymakers over the past 8 years, as the first waves of the crisis first rushed onto the Bank's doorstep, and then as solutions flowed back out across the system, has been vital to our effectiveness. The staff who do this work are a credit to the institution. As public servants they contribute every day to delivering our mission to promote the good of the people of the United Kingdom by maintaining monetary and financial stability. The changes we are making public today will ensure they can continue to do that important work effectively.

7. Open about our business

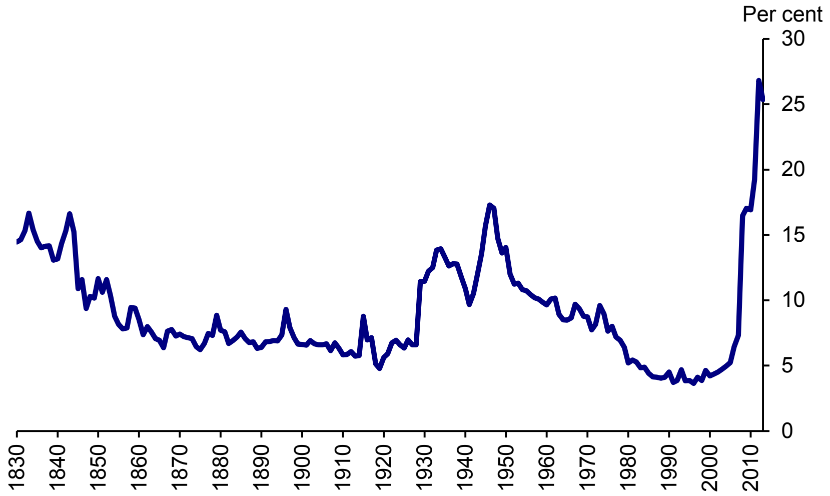
The Bank's balance sheet has been at the heart of the financial system for over 300 years, and remains our most important policy tool. The innovations and adaptations in recent years have meant that it has been central to the flexible and effective response to all of the major policy challenges faced by the Bank since the onset of the financial crisis. And I am sure it will be a vital part of everything we do in future.

Over that period, we have re-learnt one of Bagehot's lessons – that ambiguity is rarely constructive. Policy is at its most effective when it is clearly communicated. We have taken major steps to improve communications around our monetary policy decisions, the framework we use to provide liquidity to the financial system, and the way we use Market Intelligence. Those changes show that the Bank of England is not just "open for business," we are also "open about our business."

---

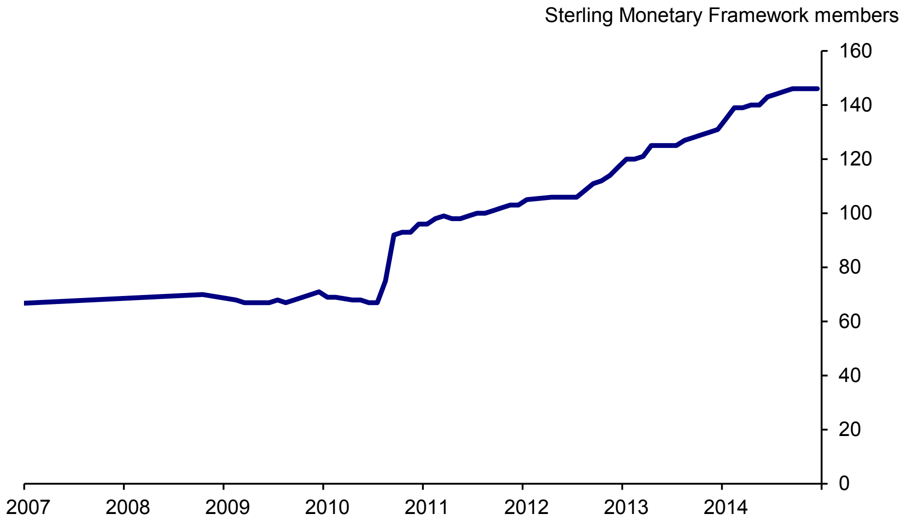
[11] http://www.bankofengland.co.uk/markets/Pages/mireview.aspx.

Figure 1:
Bank of England Balance Sheet as a share of nominal GDP



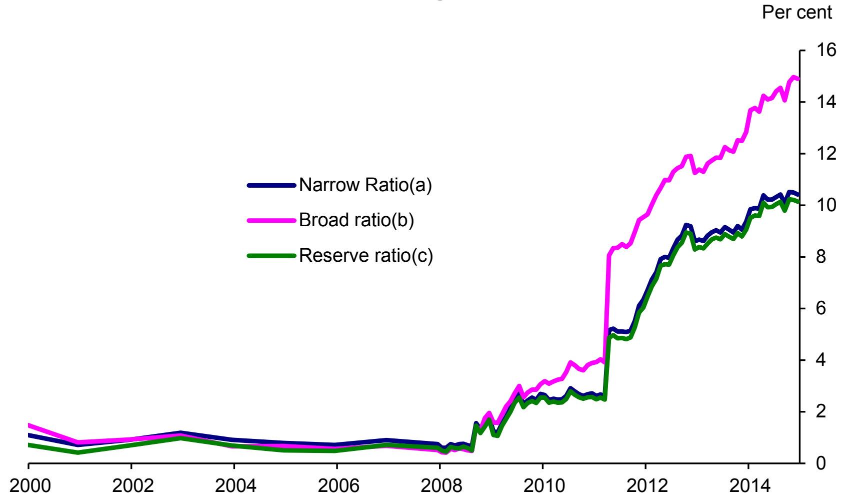
Sources: ONS, www.measuringworth.org/datasets/ukgdp/result.php# and Bank calculations. A variant of this chart was originally published in a speech by Andrew Haldane (2009), "Banking on the state," http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech409.pdf.

Figure 2:
Membership of the Sterling Monetary Framework



Source: Bank of England.

Figure 3:
Sterling liquid assets relative to total asset holdings of UK banking sector(a)



Sources: Bank of England and Bank calculations.

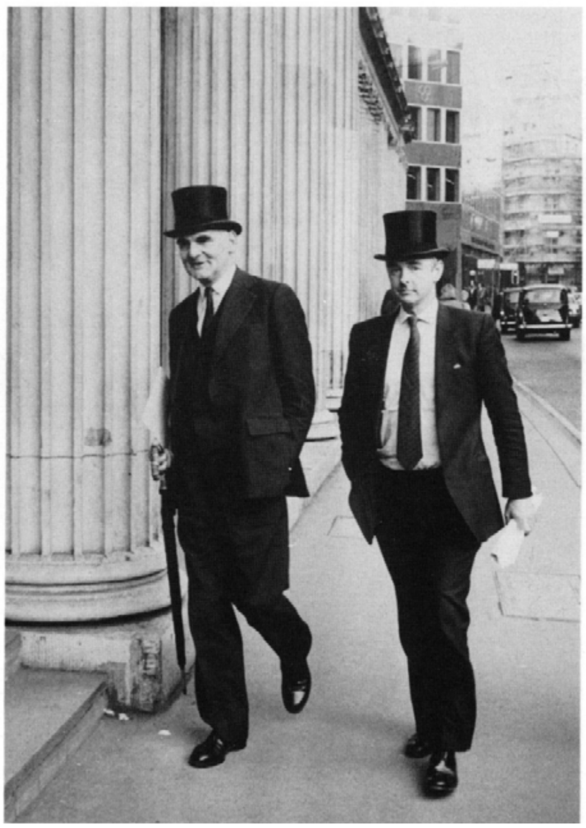
(a) Data for building societies are included from 2010 onwards. Prior to this, data are for UK banks only.

(b) Cash + Bank of England balances + money at call + eligible bills + UK gilts.

(c) Proxied by: Bank of England balances + money at call + eligible bills.

(d) Cash + Bank of England balances + eligible bills.

Figure 4:
Sir Nigel Althaus (left), Senior Broker to the Commissioners for the Reduction of the National Debt, 1982–1989, with Roger Daniell (right), his deputy



References

Warsh, K. (2014) "Transparency and the Bank of England's Monetary Policy Committee", http://www.bankofengland.co.uk/publications/Documents/news/2014/warsh.pdf.

Bagehot (1873) "Lombard Street", John Wiley & Sons, Inc.

Carney, M (2013) "The UK at the heart of a renewed globalisation", http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf.

Carney, M (2014) "One Mission. One Bank. Promoting the good of the people of the United Kingdom", http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech715.pdf.

Clapham, J, (1944) "The Bank of England A History," Cambridge University Press.

Fisher, P (2010) "Managing Liquidity in the System: The Bank's Liquidity Insurance Operations," http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech450.pdf.

Fisher, P (2012) "Liquidity support from the Bank of England: The Discount Window Facility," http://www.bankofengland.co.uk/publications/Pages/speeches/2012/561.aspx.

Giuseppi, J (1966) "The Bank of England", Evan Brothers Limited.

Hauser, A (2014) "Lender of last resort actions during the financial crisis: seven practical lessons from the United Kingdom," in: Rethinking the lender of last resort, BIS Papers, No. 79, pp 81–92.

Plenderleith, I (2012) "Review of the Bank of England's Provision of Emergency Liquidity Assistance in 2008–09", http://www.bankofengland.co.uk/publications/Documents/news/2012/cr1plenderleith.pdf.

Tucker, P (2004) "National Association of Pension Funds Investment Conference: Keynote Speech," http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2004/speech216.pdf.

Tucker, P (2014) "The lender of last resort and modern central banking: principles and reconstruction," in: Rethinking the lender of last resort, BIS Papers, No. 79, pp 10–42.

Winters, B (2012) "Review of the Bank of England's Framework for Providing Liquidity to the Banking System", http://www.bankofengland.co.uk/publications/Documents/news/2012/cr2winters.pdf.

Wormell, J (1985) "The Gilt-Edged Market", George Allen & Unwin Publishers.