Monetary policy and central bank asset purchases: Substitutes and complements – speech by Huw Pill

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Speech

Good evening everyone.

It is a great pleasure to have the opportunity to speak here at the Institute of Directors and participate in the long-running Beesley Lecture series.

As his prodigious academic record and contributions to public policy attest, Professor Michael Beesley was among the most influential industrial and regulatory economists of his day.

With the passage of time, his advocacy of road pricing in the 1960s looks increasingly prescient. And, even after almost four decades, his guidance of privatisation and shaping of the subsequent regulatory environment continue to govern the structure of important UK network industries, such as rail and telecoms.

It is a great honour to have this opportunity to contribute to the lecture series he created.

Professor Beesley's expertise lay in industrial and regulatory economics, whereas at the Bank of England my focus is – naturally enough – on monetary and macro economics. I had originally hoped to bridge this gap by discussing how the Bank's Monetary Policy Committee (MPC) seeks to 'regulate' price developments by steering CPI inflation back to it 2% target.

But, in an earlier lecture in this year's series, Professor Sir John Vickers has already taken that route. While unfortunately I could not attend his presentation, I understand he spoke on the Bank's largely successful experience of inflation targeting over the past twenty-five years, concluding with some remarks on the challenges for UK monetary policy posed by the current difficult environment.[1]

Even though that topic has already been covered, it would be remiss not to say a few words about the monetary policy outlook.

The outlook for monetary policy

Since I re-joined the Bank's staff just over a year ago (and became a member of the MPC), we have been in the process of tightening monetary policy.

Bank Rate has been raised at each of the past eight meetings, and now stands at 3%.

The large portfolio of gilts accumulated as a result of quantitative easing (QE) is being run down: since March, by ceasing to reinvest the proceeds of maturing bonds; and, since the start of this month, by selling gilts back to the market.

The language surrounding monetary policy has shifted dramatically: from so-called forward guidance suggesting that Bank rate would remain at its effective lower bound until economic slack had eroded, to a more data-dependent outlook for interest rates reflecting current concerns over the persistence of inflationary pressures.[2]

This substantial shift has been driven by two factors.

Normalisation of the monetary policy stance First, the stance of monetary policy needed to be normalised after more than a decade of exceptional ease, originally established in the face of the global financial crisis and then maintained more-or-less until this time last year. (Of course, the 'normalisation' implied here relates to historical norms for the level of Bank Rate and size of the Bank's balance sheet.)

With the failure of Lehman Brothers in 2008, Bank Rate was quickly floored at its effective lower bound, and additional easing was then provided through large-scale asset purchases. The resulting highly supportive overall stance was justified by a combination of downside risks to the inflation target, a weak economic outlook and tensions in the financial system, all of which had emerged in the aftermath of the financial crisis. The subsequent euro area sovereign crisis, the uncertainties created around the Brexit referendum, and the onset of the pandemic were seen as perpetuating and / or amplifying those risks.

At least in the eyes of some MPC members and commentators, accommodative policy over the past decade was also motivated as a way of 'buying insurance' against the possibility of a further deterioration in the economic outlook or a renewed bout of market dysfunction.

Insuring yourself against unpleasant outcomes makes sense. But insurance comes at a cost. For a monetary policymaker the premium paid to 'buy insurance' is the cost of having to alter the policy stance should the risks against which the insurance was bought not materialise.

By nature, such a 'risk management approach' at that time implied erring on the side of offering more policy support – in practice, of doing more, rather than less, QE – in order to stave off the potential impact of risks that were viewed as heavily skewed to the downside.[3] This motivation was bolstered by fears about the effectiveness of monetary policy transmission as Bank Rate reached its effective lower bound, as well as potential downward rigidity in wage and price setting.[4]

Asymmetries in the structure of the economy, in policy transmission and in the distribution of shocks all served to justify – at least on occasion, for some MPC members – an offsetting asymmetry in setting the monetary policy stance.

As the post-pandemic recovery became better established last year, these risks receded – and the need to maintain an 'ultra-accommodative' stance receded with them. What's more, the risks themselves became more symmetric, especially as Bank Rate moved away from its lower bound, and concerns about monetary policy transmission and downward nominal rigidities diminished.

As a result, the case for 'buying insurance' using monetary easing via QE fell away. By its nature, an asymmetric 'risk management' approach to setting monetary policy designed to protect against skewed downside risk is inevitably somewhat over-stimulative should those downside risks not materialise. The challenge is then to manage the impact of this insurance premium, and ensure that it does not lead to departures of inflation from target.

Just to be clear, I don't see this insurance premium as being an important driver of inflation's rise above target over the past year. That rise follows from new shocks to the UK economy, which I will discuss in a moment. Rather than in the form of inflation, the insurance premium to protect against downside risks through risk management has been paid in complicating what was anyway set to be a challenging process of monetary policy normalisation.

By the autumn of 2021, the need to start tightening the monetary policy stance was becoming more evident as those new inflationary shocks mounted.

That process was always likely to prove challenging. Aside from the substantial communication and operational challenges involved, the very generous liquidity conditions established over more than a decade could have generated pockets of vulnerability in the financial sector, as the discipline on position-taking and balance sheet management imposed by liquidity constraints in normal times had been relaxed, at least for a time.[5]

To manage these concerns, the MPC set out a transparent strategy for normalising monetary policy centred on its plan to run down the stock of assets accumulated through QE in a gradual and predictable manner.[6] This plan has governed the quantitative tightening (QT) programme over the past year.

Addressing new inflationary shocks But monetary policy cannot be put on an autopilot. Any plan has to be conditional on economic conditions, and responsive to economic shocks and disturbances.[7] The MPC has flagged that it will use Bank Rate as its active instrument to address new shocks as they emerge, leaving the QT programme to run 'in the background' as long as market conditions permit.

That naturally brings me to the second rationale for the substantial tightening of the monetary policy stance over the past year: the incidence of new inflationary shocks. Two shocks in particular stand out: the very sharp rise in wholesale European gas prices over the past year; and the decline in participation in the UK labour market (against a backdrop of sagging market competition in the goods market).

The rise in gas prices has four important characteristics.

First, it genuinely was a shock. Looking back at the first speech I gave as an MPC member this time last year,[8] gas prices barely featured. Rather the focus was on supply chain disruptions and the potential threat of the Omicron variant, which had just started to emerge as I spoke in Newcastle.

Second, the shock was large. Although it has eased somewhat in recent months, the January European wholesale gas price future – most relevant for next year's household energy bills that enter the CPI basket – rose more than ten times to its August peak.

Third, these gas price rises passed-through to the CPI inflation that the MPC targets relatively quickly: in a matter of months – certainly at a shorter horizon than the 18-24 months typically associated with the lagged pass-through of monetary policy actions to inflation developments.

And fourth, higher gas prices exerted an adverse supply-side effect on the UK economy, and thus induced a difficult trade-off for monetary policy: inflationary pressures rose at a time when economic activity weakened.

Taken together, these characteristics implied that gas price driven volatility in CPI inflation was inevitable. Given the famous 'long and variable lags' in the transmission of monetary policy, an immediate policy response to the gas price shock could not have prevented some rise in headline inflation.[9] In line with its remit, the MPC needed to act to steer inflation back to its 2% target on a sustainable basis, in a difficult environment where the adverse terms of trade impact of higher imported energy prices weighed on domestic real incomes and spending.

In doing so, it was crucial that monetary policy was prepared to act to contain so-called second-round effects in price, wage and cost developments, which threaten to impart a self-sustaining momentum to inflation, even as the original impetus to higher inflation from rising gas prices dissipates.

By its nature, that more persistent component of inflation would last to the horizons at which monetary policy does have an effect on price developments – it is thus any such persistence in inflation that the MPC (in its recent communication) has flagged as the driver of more 'forceful' policy actions.

This is where the impact of higher gas prices interacts with developments in the labour market. Even as economic activity in the UK has weakened as higher gas prices weighed on household spending power, the labour market has remained tight. The unemployment rate recently reached its lowest level since the mid-1970s. Recruitment difficulties in a tight labour market has supported stronger underlying wage growth. Taken together with the supply chain disruptions that accord firms pricing power in supply chains, this tightness creates conditions conducive to the emergence of the second-round effects we fear.

Behind the labour market tightness lies a decline in participation rates among the working age population, particularly those in the 50-65 age group. The reasons behind this decline remain the subject of controversy, but the impact of the pandemic on early retirement and long-term health, as well as underlying demographic developments, all seem to have played a role.[10] Crucially – and just like the rise in gas prices – rising inactivity among the working age population represents an adverse supply shock, which adds to the difficult shorter-term trade-offs facing monetary policy.[11]

Looking back to a year ago, the MPC debated whether the prospective end of the furlough scheme introduced during the pandemic would release furloughed workers into the labour market and ease the tightness emerging in the labour market. This was a difficult judgment to make, given that the furlough scheme was without precedent.

As it turned out, that easing did not materialise: through the middle of this year, the labour market has continued to tighten and has proved tighter than we had expected, largely owing to the adverse developments in participation that we did not fully foresee.

Now that the economy has slowed (and probably entered recession), we are starting to see labour market indicators turn. Vacancies have stabilised and there are tentative signs they will fall from their historically high levels. Should economic slack emerge and unemployment rise as the latest MPC forecasts imply, that will weigh against domestic inflationary pressure and ease the threat of inflation persistence.

It is these two factors – the evolution of energy prices and developments in domestic labour markets – as well as the policy responses to them, such as the fiscal announcements made last week, that drive my current assessment of the outlook for monetary policy. If you like, these are the main arguments of my monetary policy reaction function, especially in so far as the typically more persistent domestically-driven dynamics of inflation stem from the labour market and corporate pricing behaviour.

As I have said on previous occasions, in my judgment there is still some more to do with Bank Rate in order to address prevailing inflationary pressures and complete the necessary normalisation of monetary policy following a decade or more of exceptional accommodation.

In line with the MPC's most recent forecast and communication and on the basis of the information we have available today, I do not anticipate the levels of Bank Rate priced in financial markets when the forecast's conditioning assumptions were frozen[12] will be required. But, given the need to contain the risk of greater inflation persistence implied by potential second round effects, further action is likely to be required to ensure inflation will return sustainably to its 2% target over the medium term.

As ever, my votes on Bank Rate at the December MPC meeting and beyond will be determined by pursuit of the inflation target, and guided by the evolution of the economic and financial data.

Conducting central bank asset purchases

But the MPC is not only taking decisions about Bank Rate. In parallel with increases in Bank Rate, the MPC has also embarked on quantitative tightening. Gilts held as a result of QE conducted over the past decade or more have been sold as of the beginning of this month, following the decision in February 2022 to cease reinvesting the proceeds of maturing bonds.

QT is another aspect of the normalisation of the monetary policy stance. The MPC has committed to unwinding its QE holdings in a gradual and predictable manner. Gilt sales are running 'in the background', rather than being responsive to month-to-month data news. As I have already discussed, responses to shocks at the margin involve what the MPC has identified as its 'active' instrument – Bank Rate.

From the outset of its communication about QT, the MPC has emphasised that, were markets to become dysfunctional, asset sales could, if necessary, be paused. This eventuality transpired in the market tensions that emerged in late September, following the then-Government's mini-budget announcement.[13]

A number of my colleagues have already described the events surrounding the decision to postpone the scheduled start of QT gilt sales in early October, as the Bank implemented financial stability operations in the form of additional gilt purchases, including purchases of indexed gilts.[14] I won't repeat that detailed description here, other than to flag that these operations were intended to restore market functioning in long-dated government bonds and reduce risks from contagion to credit conditions for UK households and businesses.

Rather I will conclude with some more general observations about the relationship between monetary policy decisions taken by the MPC and financial stability operations conducted by the Bank. Not much of this is new – indeed, I have written about these issues in the past,[15] colleagues at the Bank have published an overview of their research into asset purchases in a recent Quarterly Bulletin article,[16] and the Bank has taken a leading role in international forums such as the Bank for International Settlements where the role asset purchases can play in promoting monetary and financial stability.[17] So I simply offer a few general high-level remarks to frame our discussion this evening.

As we saw with the onset of the global financial crisis, in the face of deflationary pressures, monetary policy makers can resort to asset purchases in the form of quantitative easing to ease the stance of monetary policy and financial conditions more broadly.

Central bank asset purchases can be seen as working in two ways.

Asset purchases as a substitute for changing Bank Rate First, they are a potential *substitute* for monetary easing via the conventional lowering of interest rates should the effective lower bound on Bank Rate bind. In this context, QE can influence the economic outlook through a number of channels.

On the basis of quantity-theoretic considerations, an expansion of the central bank's monetary liabilities may raise inflation expectations directly. QE can also offer guidance to the market about the Bank's plans for interest rates. In short, QE may work through a *signalling channel*.

The increase in central bank reserves associated with QE may lead to portfolio rebalancing, as banks attempt to restructure their balance sheets by buying financial assets or making loans. More generally, the absorption of duration from markets associated with Bank of England purchases of government debt financed by the creation of central bank reserves can trigger efforts by a broader set of market participants to rebalance portfolios, leading to a bidding up of asset prices. Higher asset prices ease the wider set of financial conditions faced by households and firms, supporting economic activity alleviating deflationary pressures. In sum, QE may also work through a *portfolio balance channel*.

As someone who has argued in the past – often in the face of considerable scepticism – for the importance of monetary and credit mechanisms in monetary policy transmission,[18] I find these channels both plausible and potentially important, even if the evidence on their empirical impact is mixed, perhaps reflecting the state contingency of both the signalling and portfolio balance channels.

Central banks should certainly be wary of suggesting that their armoury is exhausted when policy rates reach their effective lower bound. Such a view both risks creating deflationary dynamics through a self-fulfilling prophecy and denies the ultimately monetary origins of price level developments.

Asset purchases as a complement to changing Bank Rate Second, central bank asset purchases (and other market interventions) can be understood as efforts to maintain the conventional interest rate channel of monetary policy transmission. By their nature, such efforts are *complements* to, rather than substitutes for, changes in Bank Rate.

To maintain monetary transmission through conventional channels at times of market stress, central banks may need support to the private sector, so as to maintain the functioning of financial markets, institutions, and infrastructures.

This has a long history: dealing with ‘banking panics’ towards the end of the nineteenth century was an important motivation for the creation of the Federal Reserve, for example; and the famous Bagehot Rule governing the provision of liquidity support to the banking system has been an important guide for central bank policy for more than a century. In common with other central banks, the Bank of England has a number of tools designed to provide backstop liquidity to banks under a range of scenarios.

But in recent years, financial intermediation via non-bank financial institutions (NBFIs) – what we used to call ‘shadow banks’ – has increased, in part because of greater regulation of the core banking system following the global financial crisis.

Of course, the main responsibility for managing the liquidity and other exposures of these institutions lies with the institutions themselves, within an appropriate regulatory and supervisory structure.[19] But as we have learnt somewhat painfully over recent decades in a variety of jurisdictions, occasions can arise where the systemic nature of liquidity risks make it difficult, if not impossible, for individual institutions to attain the resilience and robustness they need.

Central banks have therefore begun to discuss the need for additional backstops. In particular, they have considered whether the need for asset purchases to address dysfunction in the markets where NBFIs operate has risen relative to the need to provide liquidity to standard banking counterparts for central banks.

Since asset purchases implemented in this context work in concert with changes in Bank Rate, they naturally take place when those interest rate changes are taking place.[20] In other words, such asset purchases would naturally happen when Bank Rate is away from its effective lower bound, and retains the flexibility to move in both directions.

Moreover, to the extent that the support offered by asset purchases represents the offer of the central bank’s balance sheet as an alternative venue for intermediation when private markets have seized up, it is natural that the asset purchases could be accompanied by asset sales, either in parallel or at least in close proximity. It is by both buying and selling (or alternatively lending and borrowing) that the central bank intermediate financial transactions between private market participants. This is the essence of the central bank acting as a central counterparty or market maker of last resort.

Relationship with financial stability There is also a natural complementarity between providing central bank support to maintain market functioning and contributing to the maintenance of financial stability. Indeed, the two go hand-in-hand.

The direction of support will depend upon the specific incidence of market failure causing market dysfunction, the structure of the financial system, and the broader flexibility of the economy. This is the essence of why such interventions will be ‘targeted’ on specific market segments. These factors will vary both over time and from one jurisdiction to another. The form of support offered by central banks will thus also vary.

Yet central banks must also recognize the limitations of their policy. In the face of crisis, they may need to be innovative in their approach. But central banks should be very wary of assuming responsibility for goals that they do not have the instruments to pursue. Re-establishing market functioning ultimately relies on the behaviour of market participants. The central bank can support this process, but in the end it is the private sector that creates and maintains the market.

Designing the appropriate tools to support and provide a backstop for market functioning is an important agenda for the global central banking community. As the example of the recent Bank of England interventions demonstrates, we are still in a learning-by-doing phase of this process.

Concluding remarks

Where does this leave the conduct of monetary policy in a context of financial stability operations? I will conclude with two points I see as key.

First, it is important to keep such financial stability operations *distinct* from monetary policy, both in terms of communication and operationally.

To the extent that such operations distort the intended monetary policy signal, they paradoxically risk interfering with monetary policy transmission, even as they are intended to support the market functioning on which that transmission relies.

Second, while respecting the need for separation between monetary policy and financial stability operations, policy makers also need to recognise the *unavoidable interactions* between the two.

After all, an injection of central bank reserves owing to a financial stability operation can have monetary implications via the portfolio balance channel just like QE. And, by design, financial stability operations will have implications for asset prices and financial markets and institutions that influence the overall stance of financial conditions, and thus highly relevant in deciding the appropriate level of Bank Rate.

Monetary policy decisions cannot be taken by the MPC entirely independently of actions implemented by the Bank for financial stability purposes: their consequences for the stance and transmission of monetary policy need to be identified and internalised in the MPC's process. Early, open and transparent communication among the various parties involved – that is, across the various relevant bodies (MPC, FPC, Bank Executive) within the Bank, among the Bank and other UK policy institutions such as the Treasury, and between policy makers and market participants – is therefore crucial.

While financial stability operations remain 'temporary and targeted' – as emphasised in the Bank's initial announcement of its recent gilt market interventions on 28 September 2022 – a natural distinction with the necessarily lower frequency evolution of monetary policy (and the monetary trends that ultimately determine inflation) exists. As others have described, this is a key element of the gilt purchases made by the Bank in September and October, in the face of market dysfunction. It has rightly be made central to the communication of recent policy interventions, in line with the need for transparency that I have highlighted.

The delicate balance between maintaining a clear distinction and internalising the inevitable interaction is important for the Bank and the wider central banking community.

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Endnotes

[1] See: Vickers (2022). “The regulation of inflation: Reflections on 25 years of the MPC,” Beesley Lecture, 9 November 2022.

[2] The MPC’s communication following its 3 November 2022 meeting set out why both the market-implied path of future Bank Rate and the path where Bank Rate was maintained at a constant 3% level were seen as inappropriate given the prevailing economic circumstances. This is a form of guidance. But the preferred outlook for Bank Rate was left to be determined by the evolution of the data.

[3] See: Evans et al. (2015) for an articulation of this approach.

[4] Experience after the global financial guidance (and the empirical evidence collected by Elsby and Solon (2019) inter alia) suggest that concerns about downward nominal wage and price rigidity may have been overplayed.

[5] See the discussion in Pill (2019) on this point.

[6] See Box A in ‘**Monetary Policy Report – August 2021**,’ Bank of England.

[7] See Broadbent (2022) on this point.

[8] See Pill (2021). This speech was given on the day the first reports in the UK media of the emergence of the Omicron variant of the Covid virus.

[9] Broadbent (2021) and Tenreyro (2022) offer some model simulations that illustrate the challenges monetary policy faced in addressing these inflationary shocks, demonstrating the substantial output costs entailed in stabilising inflation at 2% if those gas prices rises had been anticipated early enough for monetary policy action to offset them.

[10] See Haskell and Martin (2022).

[11] Of course, rising inactivity will also have demand effects. After all, Says Law implies that ‘supply creates its own demand’ (or in this case, the destruction of supply leads to the destruction of demand). That perspective is embodied in the Bank’s core forecasting model, at least over the long run. The inflationary pressures identified here are associated with shorter-term transitions before Says Law holds.

[12] In other words, the market prices prevailing on average in the 7-day window ending on 25 October 2022, which implied a peak in Bank Rate of 5¼% in the second half of 2023. The MPC had decided to reduce the window over which it averaged UK asset prices in order to construct the conditioning assumptions for its forecast in order to exclude the peak of the market turmoil that had emerged at the end of September and early October.

[13] The MPC had delegated responsibility for judging whether markets had become dysfunctional and the operational decisions about pausing QT auctions to the Bank Executive.

[14] In particular, Sir Jon Cunliffe’s letters to the Treasury Select Committee (Cunliffe, 2022a,b) and a recent speech by Andrew Hauser, the Bank’s Executive Director for Markets (Hauser, 2022) offer a detailed account of the context and character of recent operational decisions.

[15] e.g. in Pill (2010) and Pill (2019).

[16] See: Busetto, et al. (2022).

[17] See: e.g. Hauser (2021).

[18] See Pill (2022).

[19] The Bank’s Financial Stability Reports have regularly discussed the risks faced and posed by the NBFI sector, in particular in the aftermath of the so-called ‘dash-for-cash’ episode in March 2020.

[20] As reflected in the subsequent discussion, in the Bank of England context, while the responsibility for setting Bank Rate lies wholly with the MPC, the responsibility for conducting asset purchases for purposes other than monetary policy lies elsewhere, likely with the Bank’s Executive. Nonetheless, the point made here holds: if asset purchases are intended to complement the setting of Bank Rate by supporting the transmission of monetary policy decisions reflected in the changing Bank Rate, then these asset purchases will take place in parallel with Bank Rate changes, rather than once the scope for Bank Rate changes has been exhausted,