Dame Harriett Baldwin MP
Chair, Treasury Committee
House of Commons
London
SW1A 0AA

Andrew Bailey
Governor

5 April 2024

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.[1] 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.

[1] Monetary Policy Report - August 2021 | Bank of England.

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. [2] 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.

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.

[2] **QE at the Bank of England: a perspective on its functioning and effectiveness, 2022 Q1 Quarterly Bulletin article**

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.[3] [4]

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.[5] 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 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.

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[3] **Letter from the Governor to the Chancellor - April 2023 - APF (bankofengland.co.uk)**

[4] **Letter from the Governor to Harriet Baldwin, Chair of TSC, 18 December 2023**

[5] See **Explanatory Note: Managing the operational implications of APF unwind for asset sales, control of short-term market interest rates and balance sheet**

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.[6] 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.[7]

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, 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.

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[6] **A journey of 1000 miles begins with a single step: filling gaps in the central bank liquidity toolkit - speech by Andrew Hauser | Bank of England** and **Market resilience, non-bank financial institutions and the central bank toolkit – practical next steps− speech by Nick Butt | Bank of England**

[7] **Financial stability buy/sell tools: a gilt market case study | Bank of England**

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.[8] 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.[9] As such, 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.[10] 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.

[8] See **Quantitative tightening: the story so far − speech by Dave Ramsden | Bank of England** – 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

[9] See **QE at the Bank of England: a perspective on its functioning and effectiveness**.

[10] See Box A in the **August 2023 Monetary Policy Report** and the recent paper by Du, Forbes, and Luzzetti (2024).

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[11], 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[12]. 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 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

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[11] See **QE at the Bank of England: a perspective on its functioning and effectiveness**.

[12] See **Letter from the Governor to the Chancellor - April 2023**

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).[13] [14] 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.[15] 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

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[13] See **Navigating market signals: MaPS for policy makers** – speech by Andrea Rosen.

[14] See, e.g. **Market Participants Survey results - February 2024 | Bank of England**

[15] See **Explanatory Note: Managing the operational implications of APF unwind for asset sales, control of short-term market interest rates and balance sheet**

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.[16]

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.[17]

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. [18] [19] Front and centre in this strategy was the need for stronger private self-insurance, market

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[16] Also see, **Bond trading, innovation and evolution: a Bank of England Perspective** – speech by Dave Ramsden

[17] See **Less is more or less is a bore? Re-calibrating the role of central bank reserves** – speech by Andrew Hauser and **Loughborough lecture: Banking today**– speech by Andrew Bailey.

[18] For more discussion of these issues, see **Financial Stability in Focus: The FPC's approach to assessing risks in market-based finance | Bank of England**.

[19] For more information, see Section 1 of **The Financial Policy Committee's medium-term priorities (2023–2026) | Bank of England**.

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.[20] 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 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.

[20] **A journey of 1000 miles begins with a single step: filling gaps in the central bank liquidity toolkit - speech by Andrew Hauser | Bank of England** and **Market resilience, non-bank financial institutions and the central bank toolkit – practical next steps− speech by Nick Butt | Bank of England**