BANK OF ENGLAND

News release

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Managing the Central Bank's Balance Sheet: Where Monetary Policy Meets Financial Stability - Lecture by Paul Tucker

In a lecture today marking the 15th anniversary of the founding of Lombard Street Research, Paul Tucker, the Bank of England's Executive Director for Markets and member of the Monetary Policy Committee, sets out the analysis underlying the Bank's announcement on 22 July of major reforms of its operations in the sterling money markets.

Mr Tucker outlines three problems with the current framework. First, it is overly complex, with up to four rounds of operations each day. Second, because fixed-rate repos span MPC meetings, the short-term yield curve pivots when the MPC is expected to change rates. Third, overnight interest rates are volatile by international standards, though less so than before an earlier round of reforms in 1996-98. These characteristics deter full participation in the sterling money markets by foreign banks, securities houses, corporate treasurers and money managers. "Less tangibly, but importantly, the reputation of the sterling money markets is impaired," he comments.

Under the planned new system announced last week, a broad range of banks will target positive balances with the Bank on average over a maintenance period lasting from one MPC meeting to the next. These "reserves" will be voluntary, Mr Tucker notes, and for the first time in its history, the Bank will pay interest on them: at the MPC's repo rate.

In order to set the official rate effectively, the Bank needs to be the marginal supplier and taker in the overnight money market. For these reasons, Mr Tucker explains, there will be standing deposit and (collateralised) lending facilities available all day to banks generally. At present only relatively few banks have access to such facilities, a flaw in the current system. Mr Tucker believes that "A mistaken emphasis on open market operations as 'setting the rate' has been one precondition for the volatility in the sterling overnight rate".

He goes on to argue that the reformed system will enable the Bank to meet, more effectively than now, increases in the demand for reserves, whether system-wide or, depending on the cause, from individual bank: "…it will take us further in the direction of Bahegot's precept that, so far as is possible, central banks should make clear in advance their preparedness to advance liquidity, against collateral and at a penal rate, in stressed conditions." He also explains how a system based on averaging with voluntary reserves will provide more choice to settlement banks in managing their wholesale payment system liquidity needs.

Overall, Mr Tucker says that "compared with the past couple of decades, the plan reflects a fundamental change in how the Bank thinks about the implementation of monetary policy and the management of our balance sheet more generally, including how we support the stability of the system." The new framework takes account of "the interactions between the implementation of monetary policy, the lubrication of the wholesale payments system, and the provision of liquidity to the banking system. All are facets of the management of central bank money and the central bank's balance sheet."

Notes to Editors

- The Bank announced the result of its review of its official operations in the sterling money markets on 22 July, having published a consultative paper 'Reform of the Bank of England's Official Operations in the Sterling Money Markets' on 7 May. It plans to publish a further consultative paper on the details of the new system during the autumn.
- Click here for further information on the Bank's current open market operations.

Key Resources

Managing the Central Bank's Balance Sheet: Where Monetary Policy Meets Financial Stability - Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2004/speech225.pdf