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News release

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Recent developments in the sterling monetary framework - speech by Paul Fisher

In a paper presented at the University of Manchester, Paul Fisher - Executive Director Markets and member of the Monetary Policy Committee - explains how the Bank uses its sterling monetary operations to help meet its two core purposes: maintaining monetary stability and contributing to the stability of the financial system.

Paul Fisher explains that, in normal times, 'reserves averaging' is employed as part of the Bank's Sterling Monetary Framework (SMF) to implement the MPC's official interest rate decision each month, with commercial banks remunerated at Bank Rate if they hit a self-determined target level of reserves. But that system has been suspended since the introduction of QE in March 2009. Instead, the Bank has operated a 'floor' system, where banks are remunerated at Bank Rate on any level of reserves. Paul Fisher reviews the merit of both systems, as well as a third model, but says the Bank ".expects to return to a reserves averaging system in due course. Presumptively, that would be after increasing Bank Rate and before asset sales began - although timing and sequencing will depend on the circumstances at the time."

Turning to look at some of the financial stability aspects of the Bank's operations, Paul Fisher explains that the Bank provides liquidity through the SMF to both individual, credit-worthy institutions and the banking system as a whole, but ".liquidity insurance must be provided in a way that takes account of the potential for 'moral hazard' - the incentive for individual banks to undertake riskier activities because of the presence of a central bank back-stop". Paul Fisher notes that this insurance can come in several forms via the SMF, including: reserves averaging, which permits day-to-day fluctuations in reserves; operational standing facilities, that allow counterparties to cope with operational disruptions or volatile markets larger unforeseen shocks day-by-day; and longer-term Open Market Operations (OMOs). The paper then examines how the Bank has recently reformed its OMO operations.

Paul Fisher notes that the Bank responded to the financial crisis in a number of different ways, including expanding the size of its longer-term reverse repo operations (LTRs) and the pool of eligible collateral. He says: "The temporary expansion of LTR lending during the crisis was very successful in its main objective of providing liquidity to the banking system. But it also raised a number of important operational policy questions for the Bank." These revolved around the size of the operations, the appropriate spread charged on different types of collateral, and the exposure of both the Bank and commercial banks to interest rate risk. As a result, the Bank enlisted the help of Paul Klemperer from Nuffield Oxford College, an expert in auction theory, to help re-design its long-term operations. That led to the replacement of LTRs with new, permanent Indexed-Long Term Repo (ILTR) operations in the summer of 2010. Paul Fisher explains how the new auctions work in detail, allocating funds against either 'narrow' or 'wider' - less liquid - collateral dependent on the spreads offered. He says: "As far as we know, the new format represents a global first for a public auction in any field."

Paul Fisher concludes by saying that while the Bank has made significant progress in reform of its operations through the crisis, ".it is unlikely to have reached the end of the development process. As experience grows with both reserves averaging and the new auctions, we will undoubtedly learn more and adjust the operations accordingly."

Key Resources

Recent developments in the sterling monetary framework – Full speech