MPC past present and future

The good, the bad and the ugly

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The good

- Clear monetary policy mandate:
  - lexicographic inflation targeting
  - Symmetric
  - Open letter procedure
- Operational independence
- Reasonable communication with Treasury (Treasury representative at meetings; monthly chats between Chancellor and Governor)
- Formal accountability to Parliament (no substantive accountability)

The good

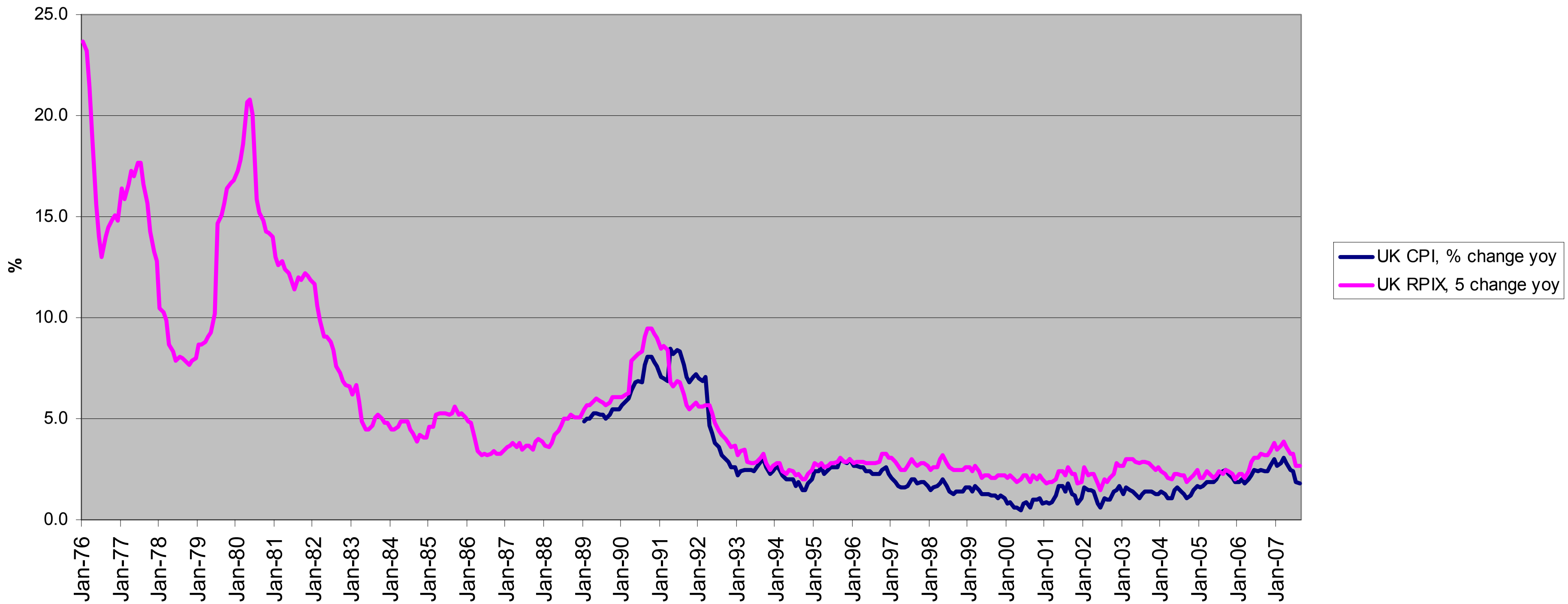
- Criteria for external appointments: independence & competence
- Individual accountability
- Procedural transparency:
  - Voting takes place (!)
  - Individual votes are reported
  - Minutes are published
  - No phoney consensus pretended when it does not exist

The good

- Performance:
  1. Low and stable inflation near target level (really since 1992 – UK ERM exit & adoption of inflation targeting)
  2. Well-anchored inflation expectations
  3. Stable growth of output
  4. BoE not party to excessive liquidity creation of BoJ, Fed & ECB (interest rates systematically below neutral levels 2001-2006)

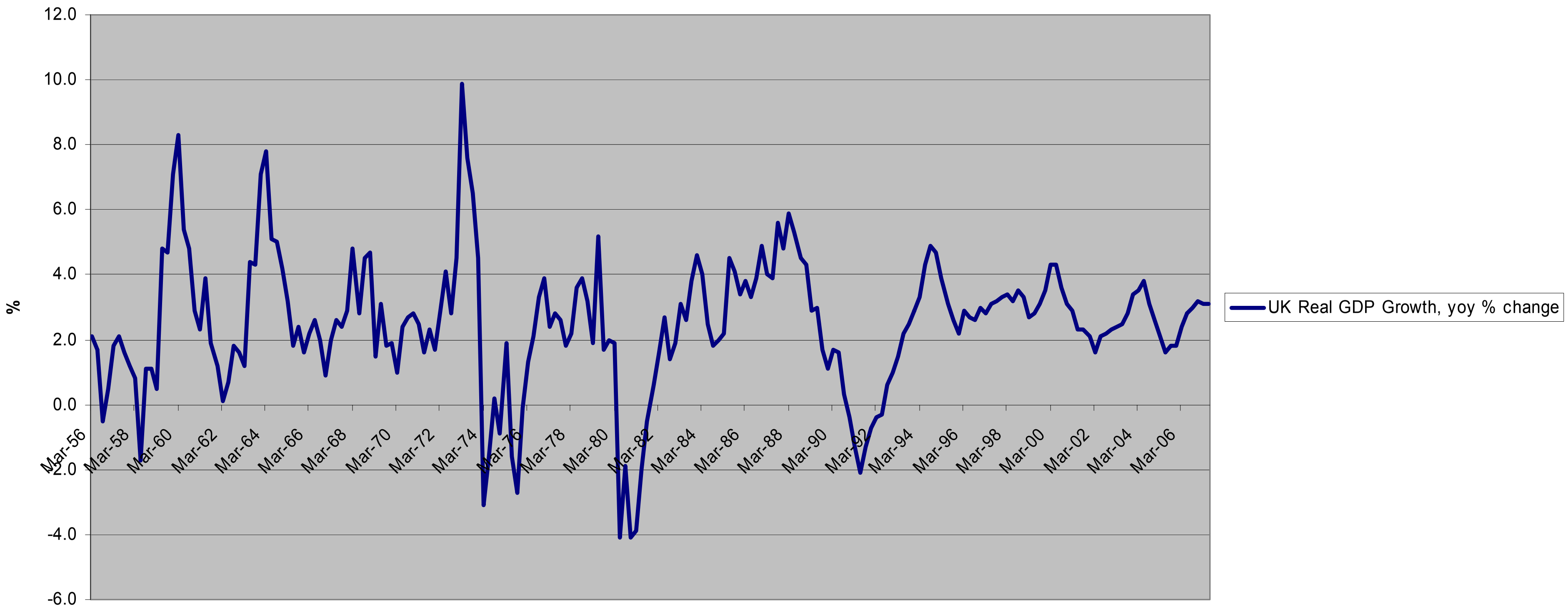
UK CPI and RPIX inflation rates

1989M01 - 2007M08 (CPI)
1976M01 - 2007M08 (RPIX)



Source: UK Office for National Statistics

UK Real GDP Growth
1956Q1 - 2007Q2



Source: UK Office for National Statistics

Bad

- Inflation target (index and numerical value) can be varied at will by Chancellor
- Price index used for operational inflation target (CPI) at best only appropriate for homeless
- Appointment procedure a shambles
- No confirmation hearings
- Term of external members; should be one longer, non-renewable term
- Reserve powers at discretion of Chancellor
- Details of vote should be published when rate decision is made

Ugly

- Role of Bank in financial stability triad
  - MOU & Tripartite arrangement deeply flawed (design problem: responsibility of Treasury and Parliament)
    - Bank has the money
    - FSA has the information on individual institutions
    - Treasury has the authority
  - Bank's liquidity-oriented OMOs flawed
    - Until recent *volte face* too restrictive eligible collateral (no private assets, liquid or illiquid)
    - Until recent *volte face* Bank only tried to set overnight rate; no attempt to influence market rates at longer maturities. Makes no sense when there is a term structure of illiquidity risk premia
    - Failure to see market liquidity as a public good (driven by network-type externalities); liquidity risk should not be privately insured but publicly. Under disorderly market conditions, liquidity should be provided freely (not at a penalty rate) to the markets by the one agency whose liabilities are intrinsically liquid, rather than privately supplied out of privately held liquid assets
    - No trade-off between moral hazard and *ex-post* insurance of liquidity risk by central bank provision of liquidity to markets (there can be such a trade-off when a specific private financial business is supported/bailed out). Provision of liquidity to illiquid markets is market failure-correcting.
  - Bank's discount window policy flawed (collateral & maturity)
    - Northern Rock's Liquidity Support Facility is what Standing lending facility ought to have been

Ugly

- Bank's Sterling money market operations:

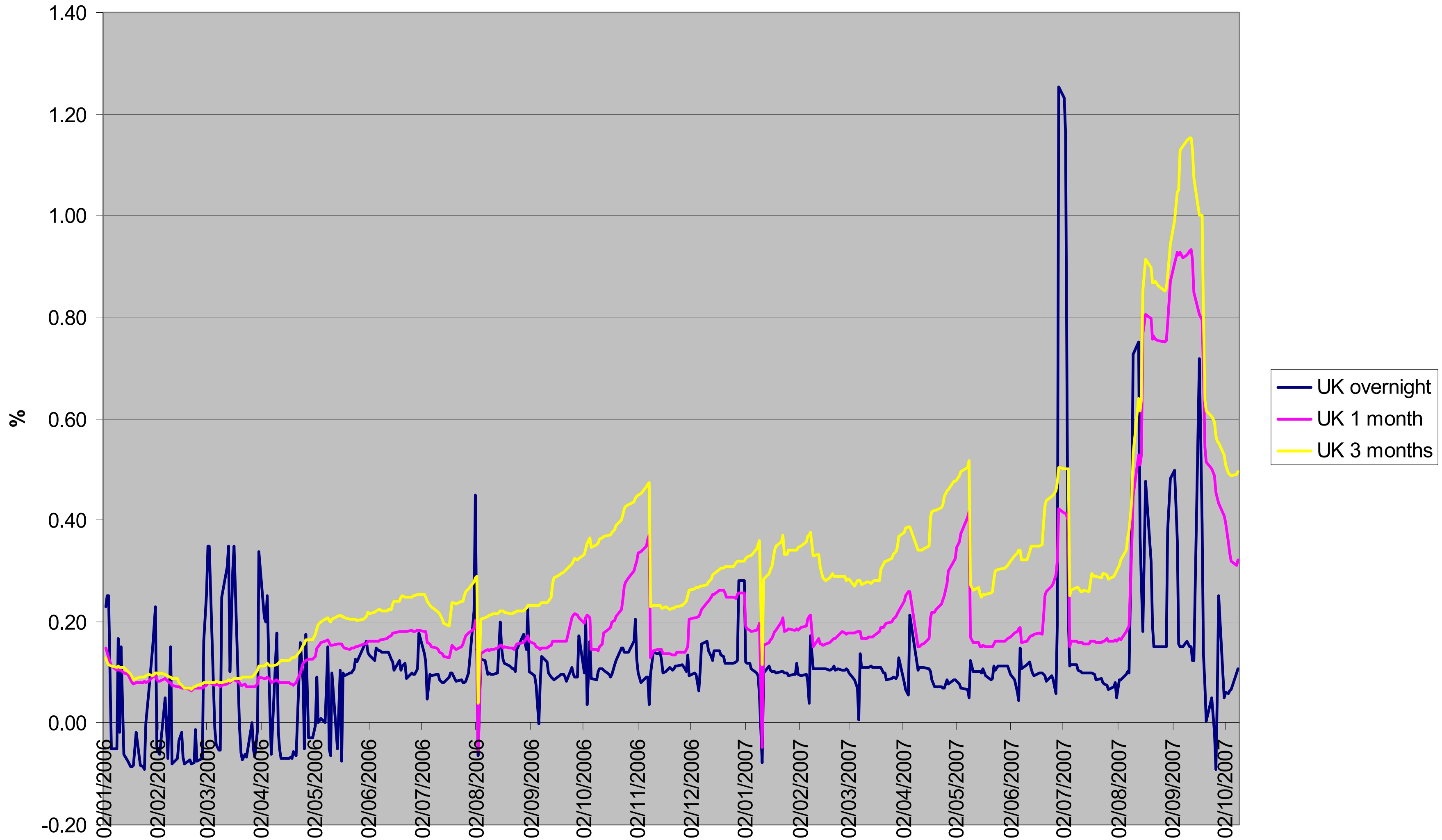
  Q: What does the MPC set when it sets Bank Rate?

  A: Target for overnight sterling interbank rate (rather like Fed's Federal Funds target)

Sterling Money Market Operations

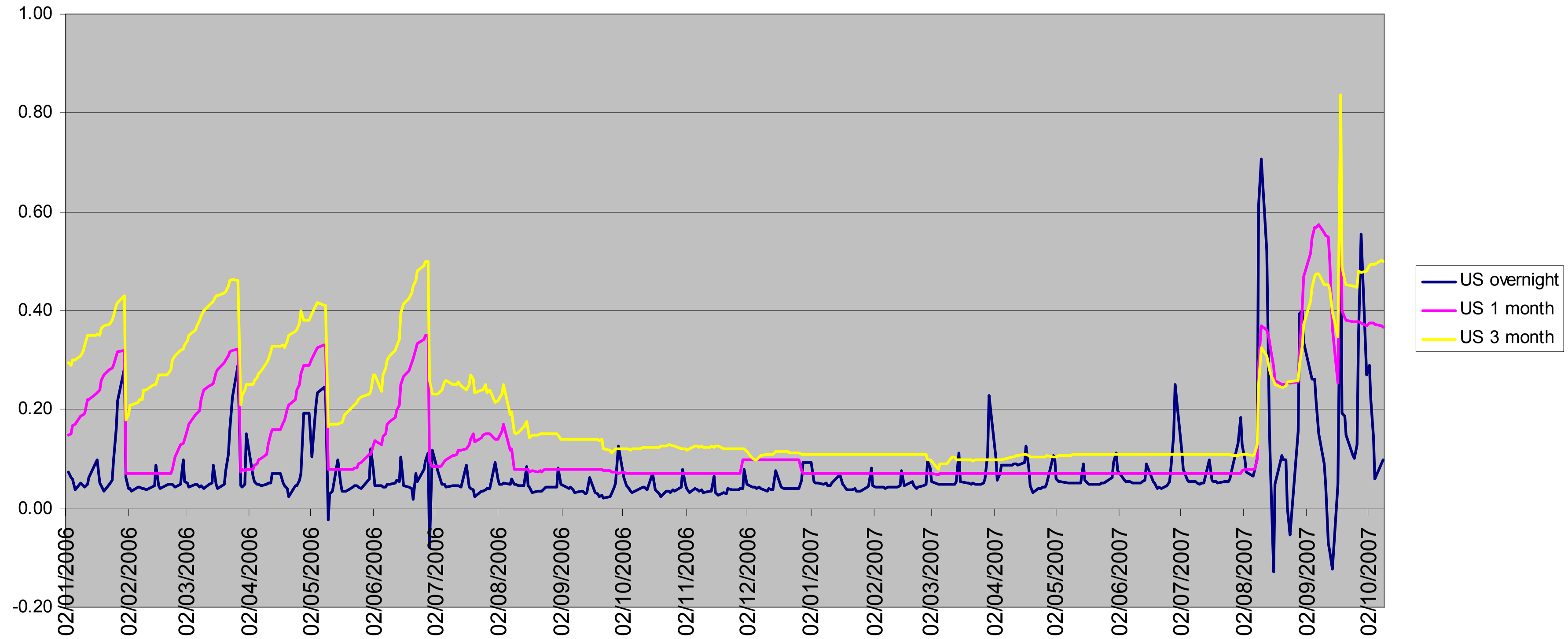
- How did the Bank do?

UK interbank rates spreads over policy rate
02/01/2006 - 09/10/2007



Source: BBA

US interbank rates spreads over policy rate
02/01/2006 - 09/10/2007



Source: Bundesbank

US interbank rates spreads over policy rate
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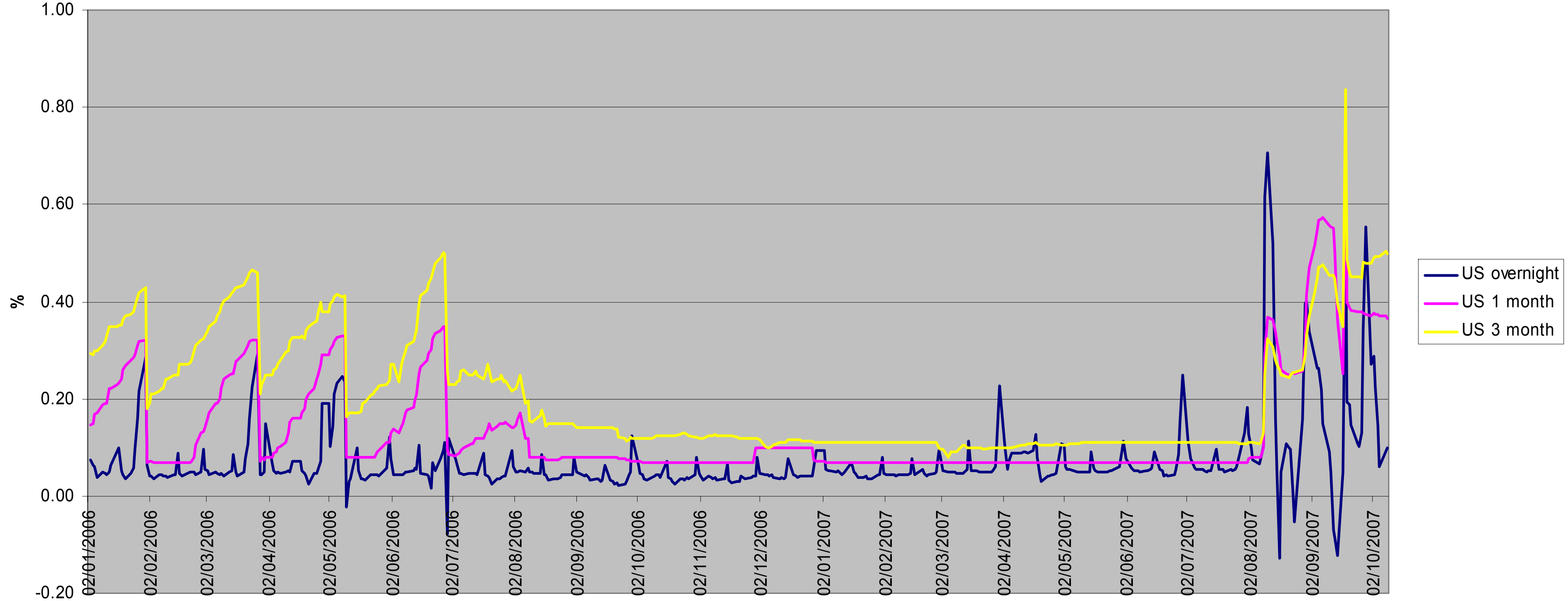

Source: Federal Reserve Board

How did the BoE do as regards interbank rate spreads?

- Not much worse, actually, than the Fed or the ECB, despite much lower volumes of intervention at all maturities
- US declining spreads in part reflect expectations of future Fed Funds target rate cuts
- Continuing high level of 3-month spread over policy rate in euro zone suggests continuing deeper problems in banking sector of euro area

Sterling Money Market Operations
Redbook Wisdom

- **Objective 1:** Overnight market interest rates to be in line with the Bank's official rate, so that there is a flat money market yield curve, consistent with the official policy rate, out to the next MPC decision date, with very limited day-to-day or intra-day volatility in market interest rates at maturities out to that horizon.

Sterling Money Market Operations

- **Objective 2:** An efficient, safe and flexible framework for banking system liquidity management - both in competitive money markets and, where appropriate, using central bank money - in routine and stressed, or otherwise extraordinary, conditions.
- **Objective 3:** A simple, straightforward and transparent operational framework.
- **Objective 4:** Competitive and fair sterling money markets.

Sterling Money Market Operations

- *Reserve-averaging scheme*. Eligible UK banks and building societies undertake to hold target balances (reserves) at the Bank on average over maintenance periods running from one MPC decision date until the next. If an average balance is within a range around the target, the balance is remunerated at the Bank's official rate.

Sterling Money Market Operations

- *Standing facilities*. Standing deposit and (collateralised) lending facilities are available to eligible UK banks and building societies. They may be used on demand. In normal circumstances, they carry a penalty, relative to the Bank's official rate, of +/- 25 basis points on the final day of the monthly reserves maintenance period and of +/- 100 basis points on all other days.

Sterling Money Market Operations

- *OMOs*. Open market operations (OMOs) are used to provide to the banking system the amount of central bank money needed to enable reserve-scheme members, in aggregate, to achieve their reserve targets. OMOs comprise short-term repos at the Bank's official rate, long-term repos at market rates determined in variable-rate tenders and outright purchases of high-quality bonds.

Sterling Money Market Operations

- Sterling money market operations represent an attempt to fix both price and quantity (or some unexplained function relating the price of repos to its quantity)
- This is at best unnecessarily complex and confusing and at worst impossible
- It undermines the ‘integrity’ of the MPC’s instrument

A sensible money market operations scheme

1. Fix (peg) overnight repo rate, i.e. stand ready to repo or reverse repo <u>any amount</u> <u>on demand</u> <u>at the policy rate</u> (Bank Rate), at any time during the working day (24 hrs?) against eligible collateral.
2. Eligible deposit-taking institutions can hold up to x % of their assets at the beginning of the maintenance periods as reserves at the Bank of England, earning the policy rate. Any deposits above that limit earn the rate on the Standing deposit facility.
3. The quantity of reserves, other deposits with the Bank and loans at the Bank's Standing (collateralised) lending facility can be varied at on demand at any time (subject to 2.)

Bank Rate and interbank rates under the proposed regime

- There still will be divergence between Bank Rate and the overnight interbank rate
  - Unsecured interbank lending
    - Default risk (small)
    - Term premium (negligible overnight)
  - Secured interbank lending
    - Default risk if collateral is not free of default risk (even smaller)
    - Term premium (negligible overnight)

Bank Rate and interbank rates under the proposed regime

- Interbank rates at longer maturities and Bank rate: divergence because of

1. Expectations of future Bank rate changes
2. Term premium (still small)
3. Default risk premium
4. Future liquidity risk premium (term structure of liquidity risk)

Implications for monetary policy of proposed new money market regime

- Clear demarcation between responsibility of MPC (sets Bank Rate and requires BoE to ensure that overnight interbank rate is always very close to Bank rate) and responsibility of BoE for provision of market liquidity as part of its financial stability mandate: intervene at any & all maturities against any collateral that can be valued

That's all folks!

References

- **Bank of England (2007), *The Framework for the Bank of England's Operations in the Sterling Money Markets (the 'Red Book')*. February** *http://www.bankofengland.co.uk/markets/money/publications/redbookfeb07.pdf*

- Buiter, Willem (2007…) *Blog*: http://maverecon.blogspot.com/