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Quantitative tightening - an interesting exchange of letters

Synopsis: The Governor of the Bank of England and the Chancellor have exchanged letters about the move from quantitative easing to quantitative tightening. The timing suggests that neither party wanted their correspondence to receive much coverage.

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If you want to put out some awkward financial news, the Friday before a Bank Holiday weekend is a good time to do so. That way you will probably miss the attention of the weekend personal finance pages and then be stale news by the time Tuesday arrives.

So it was that on Friday 28 April the Treasury and the Bank of England published an exchange of correspondence between their respective heads about the 'asset purchase facility' (APF). If you are wondering what the APF is, it is the label that the Bank of England (BoE) uses when talking about the process of quantitative easing (QE). Until it started to unwind the QE programme in February 2022, the Bank had spent £875bn on purchasing gilts and a further £20bn on commercial bonds (the assets).

Andrew Bailey's letter to Jeremy Hunt explained that the Bank's APF holdings had since shrunk to £821.3bn (including £6bn in commercial bonds) as a result of…

- £37.1bn of gilts reaching maturing without replacement;
- £22.8bn of gilts being sold at regular auctions in the market;
- £14bn of commercial bond that had maturated, been sold by auction or sold to bond issuers in buybacks.

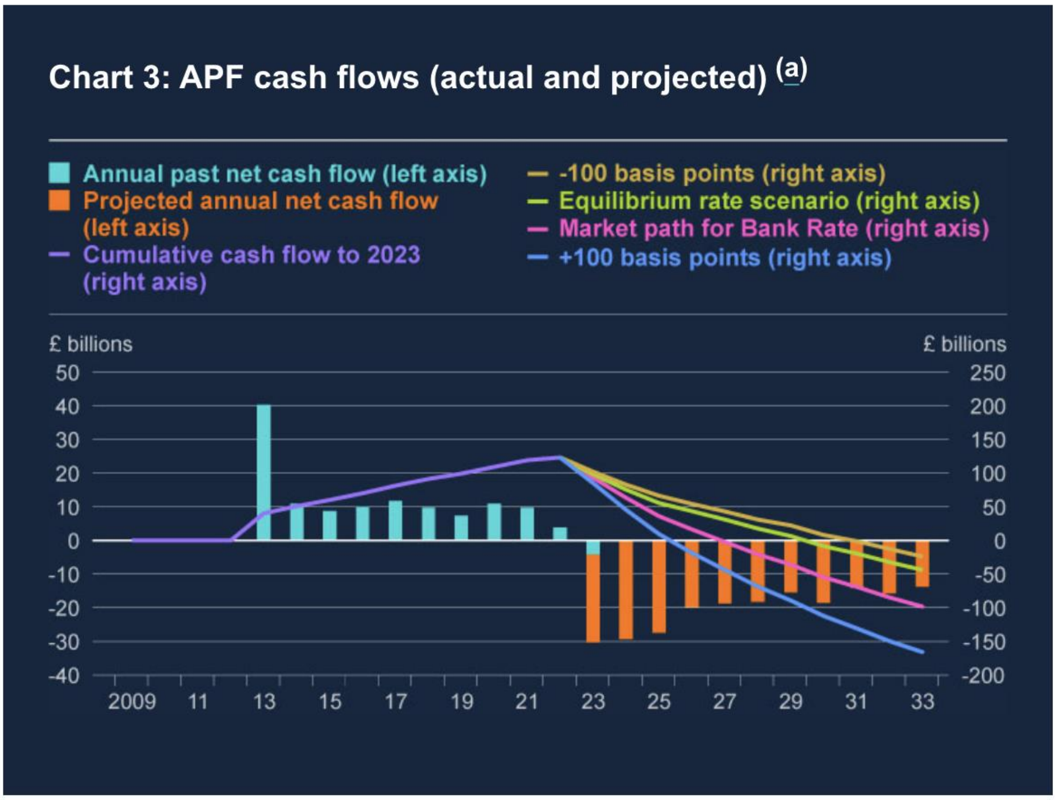
The Bank's current aim, as determined by the Monetary Policy Committee, is to bring down its total holdings to £758bn by September 2023.

Where matters start to become worthy of a Friday news release is when consideration is given to the cashflows between the Treasury and the BoE. As Mr Bailey notes, in 2012 the Bank and Treasury agreed to transfer the bond interest payments received on the Bank's holdings, net of interest costs and other expenses, to the Exchequer. From then until September 2022, the Treasury benefited to the tune of 'around £123bn' because the bond coupons were greater than the base rate interest the Bank was paying on the reserves created by the QE process.

With the rises in the Base (Bank) Rate (and another likely next week), the cashflow is now heading in the opposite direction because, in 2009 when QE began, the Treasury agreed to indemnify the Bank against any QE-related losses. It is not only the interest differential which is now hurting the Treasury.

The sharp rise in bond yields over the last 18 months has also meant that the Bank is facing losses on its bond sales. It has already faced losses at maturity where the original APF purchase price was above par. The Office for Budget Responsibility (OBR) in chapter 4 of its March 2023 Economic and Fiscal Outlook devoted just over two pages (117-119) to examining the impact of these cash flows. The bottom line of the OBR's calculations is that between 2022/23 and 2027/28 the Treasury will have to cover losses of £108bn that the Bank will incur. £29bn of that falls in 2023/24. To cover those losses, the Treasury has to borrow more.

As the OBR says, '...it has always been expected that one day the direction of these flows would reverse', but the change 'has been dramatic in its speed and scale'. That judgement is well illustrated in a chart recently published by the Bank itself in its latest quarterly APF report...



Sources: Bloomberg LLP for market rates as at 31 March 2023. Bank of England calculations for data in relation to APF cash flows.

(a) The stock of assets used for the projection of cumulative cash flows is based on holdings as at 31 March 2023, consistent with the holdings reported in Table A.

Comment

The OBR rightly notes that, *'...in a world where the yields and prices of longer-dated government bonds reflect expectations of the future path of Bank Rate, it should be expected that the gain from building up and running down a portfolio of gilts financed at Bank Rate would, on average, net out to zero.'*

But after ten years of Treasury upside, the trip to zero is now distinctly downhill.

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