PositiveMoney

Treasury Committee: Reducing the fiscal costs of interest rate rises

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The way in which the Bank of England is conducting monetary tightening is resulting in an enormous bill for the Treasury. Much of this will be transferred to commercial banks, who receive the base rate of interest on their total holdings of risk free reserves, and are currently recording record profits by not passing on rate rises to savers. The fiscal costs of monetary tightening could be reduced by introducing 'tiered reserves', as has been implemented in the Eurozone, Japan, and previously in the UK.

As a result of the interaction between interest rate rises, quantitative easing (QE) and most importantly, the manner in which the Bank of England remunerates central bank reserves at its base rate, tens of billions of pounds of public money is being transferred from the Treasury to the Bank of England, much of which is being paid to commercial banks.

- The Bank of England began paying interest on all reserves held by banks in 2009 following the introduction of quantitative easing (QE).
- Ordinarily, the interest on reserves are covered by the income the Bank of England receives on the bonds it has purchased via QE, but with interest on reserves rising higher than that paid by those bonds, and the Bank's sales of bonds at a loss through quantitative tightening (QT), the Treasury, which indemnifies the scheme, is forced to cover the losses incurred.
- In the current context, losses have resulted most significantly from the interest paid on commercial bank reserves, but have also resulted from the Bank of England's approach to QT, which has seen the Bank sell bonds it has purchased at a loss.

Almost 30bn[1] has already been paid by the Treasury to the Bank of England. The Bank estimates that overall costs could reach £150bn, and recent costs have exceeded expectations.

- In July, the Treasury transferred £14.3bn to the Bank of England, £5.4bn more than the OBR's initial forecast.
- Deutsche Bank's chief economist has also projected even greater costs than OBR predictions, estimating the total net cash transfer in the current fiscal year could reach £48.7bn, with losses in 2024/25 reaching £38.1bn.

The ultimate impact of these payments from the Treasury to the Bank of England is a large transfer of public money to commercial banks in the form of interest payments on central bank reserves.

[1] The Treasury has so far made four payments to the Bank of England's Asset Purchase Facility (APF). Payments are made quarterly. £14.3bn was transferred in July 2023, £9.8bn in April 2023, £4.2bn in January 2023 and £0.8bn in October 2022.

- Former Bank of England deputy governor Sir Paul Tucker estimates that banks are due to receive £42bn and £33bn in 2023 and 2024 respectively from interest paid on reserves.

By not passing on rate rises to depositors, the UK's largest commercial banks have made record profits in the first half of 2023.

- The UK's big four banks - HSBC, Barclays, Lloyds and Natwest - reported pre-tax profits of £28.93bn for the first six months of 2023. This is a nearly 725% increase on the same period in 2020, before rates started rising, and suggests the big four could be on track to make record annual profits of nearly £60bn this year.

The huge transfer of public money to commercial banks is not inevitable. Tens of billions of pounds a year could be saved by the Bank of England moving to a system of 'tiered' reserves.

- Under a tiered reserve system, the Bank of England would only pay the full base rate on a portion of reserves necessary for implementing monetary policy.
- This would mean that monetary policy would still be transmitted via raising the base rate, but would not come at such large expense for the taxpayer.
- The European Central Bank (ECB) has recently announced the introduction of a tiered system in which minimum required reserves are remunerated at 0%, on the basis that such a system retains the effectiveness of monetary policy whilst reducing interest payments.
- Analysis from the New Economics Foundation finds that tiered reserves could save the government up to £57bn by March 2025.
- A tiered reserve system has also been supported by IMF economists and former Bank of England Governor Paul Tucker, among others.

Suggested questions for the Bank of England:

1. Is the Bank still underestimating the likely costs to the Treasury resulting from the way it is implementing monetary policy?
2. Has the Bank considered the merits of following the ECB and moving to a system of tiered reserves, given the side-effects of the current framework that has resulted in payouts to commercial banks at public expense?
3. What do you assess to be the relationship between the Bank of England's monetary policy and record bank profits? Are there distributional impacts that should be mitigated?