On intervention

IN THE ACT WINTER PAPER, SPONSORED BY BARCLAYS, PAUL FISHER, THE BANK OF ENGLAND'S EXECUTIVE DIRECTOR FOR MARKETS, AND A MEMBER OF ITS MONETARY POLICY COMMITTEE, EXPLORED THE CURRENT HEALTH OF THE FINANCIAL MARKETS AND THE MEASURES TAKEN BY THE BANK TO AVOID ECONOMIC MELTDOWN. **PETER WILLIAMS** REPORTS.

As the credit crunch took hold, governments across the world introduced a range of policies to prevent economic meltdown. Actions taken have included recapitalising some of the biggest banks, guaranteeing some of their funding, expanding liquidity assistance and, in Fisher's words, "setting appropriately accommodative fiscal and monetary policies".

Asset purchases were part of the response. At the peak the Bank spent nearly £3bn on commercial paper and corporate bonds (see Figure 1). This figure is sometimes compared with the £198bn of gilts purchased by the Bank, which prompts the question why the Bank did not buy more private sector assets. Fisher said the question reflected a "perhaps natural misunderstanding of the different purpose of these interventions. The gilt purchases were intended as a monetary policy operation to inject a substantial amount of money into the economy."

INTERVENTION BY THE AUTHORITIES. Fisher examined the rationale for the Bank's interventions in the corporate credit market, reviewed the schemes in place and evaluated the results to date. He highlighted the fact that the Bank intervenes routinely to implement monetary policy operations and provide liquidity insurance to the banking system. These operations are normally restricted to the counterparties of banks and building societies and stem directly from the Bank's core responsibilities of maintaining the country's monetary and financial stability.

Fisher emphasised that these responsibilities did not give the Bank a mandate or the ability to "provide a source of long-term funding for the commercial banking system" and that it did not "have access to funds that could be used to sustain commercial lending operations".

He pointed out that the Bank couldn't raise taxes, lacked significant retail deposits and was not permitted to borrow large amounts from the wholesale markets for non-monetary purposes. More generally, in a capitalist economy it is private sector (or, in some cases, national) savings, which ultimately fund the banking system. It is the job of financial intermediaries to translate those savings efficiently into private sector spending. Fiscal authorities access private sector funding via taxation or by borrowing on a large scale.

In many instances in UK economic history the government has intervened to support private markets or individual businesses. The risks associated with such action – inefficient allocation of capital in the economy and loss of public money – are well known. However, successful intervention can correct a market failure or achieve a wider social objective.

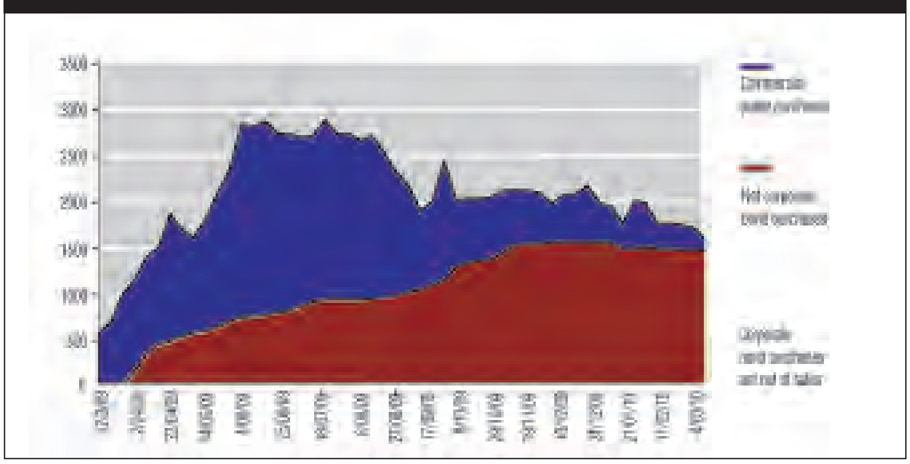
While the merits of such interventions need to be argued on a case-by-case basis, Fisher suggested they should be undertaken with the support of the democratic political system and implemented as a fiscal operation. He pointed out that during the recent financial crisis the UK government had made a number of such interventions, such as the enterprise finance guarantee and the vehicle discount scheme (the so-called scrappage scheme).

SPECIAL LIQUIDITY SCHEME. In relation to the Bank's special liquidity scheme, which provided £185bn for the banking sector, Fisher noted that it provided a temporary collateral upgrade for banks, allowing them to obtain funding from the market. He reiterated that the special liquidity scheme would close at the end of January 2012, by which time participants should be funding their balance sheets by other means.

The special liquidity scheme was probably the single most generous liquidity support scheme introduced by a central bank during the crisis. It did not provide the banks directly with funding, but swapped illiquid private sector assets held by the banks for highly liquid treasury bills borrowed from the Debt Management Office (DMO). The commercial banks then obtained their funding from the market by repo of the treasury bills.

Fisher said that if the special liquidity

Figure 1: Corporate purchases through the Bank's asset purchase facility



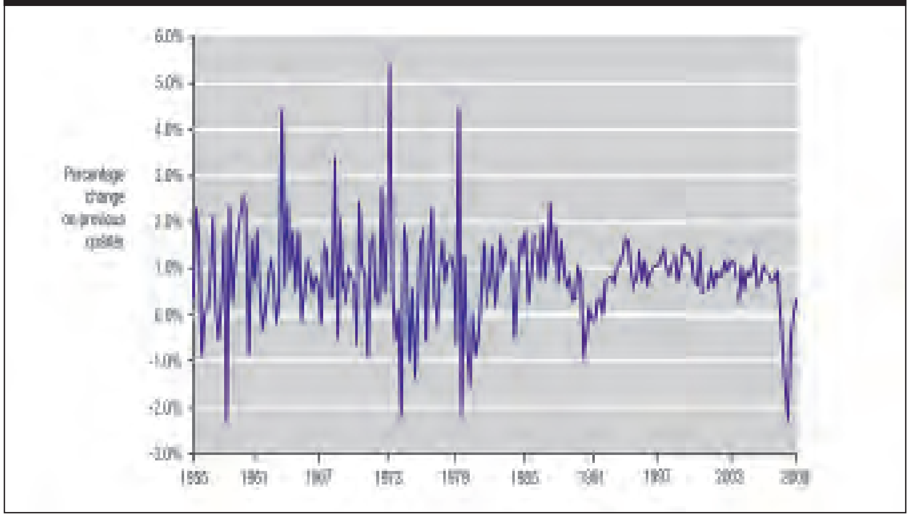
scheme were to be extended – as has been requested by some – it would equate to an implicit subsidy for specific banks. Albeit for a fee, those banks would be funding on an ongoing basis their illiquid, risky assets by borrowing at "risk-free" government rates. This, said Fisher, would give a significant advantage to banks that had most recourse to the scheme. But central bank operations are not about protecting individual banking franchises; they are about ensuring overall monetary and financial stability.

MARKET MAKER OF LAST RESORT. Since a central bank is also concerned with maintaining conditions for the stable provision of financial services to the wider economy, it may step in as market maker of last resort (MMLR). In explaining this, Fisher set out some of the principles that can allow such operations to be conducted, consistent with a central bank's other objectives.

As the exchange of letters between the Bank and the chancellor on the asset purchase facility in January 2009 set out, the purchase of such assets, initially financed by the issue of treasury bills, "was intended to improve the functioning of markets and so was consistent with an MMLR function"; it also provided a framework for quantitative easing.

Evaluating the asset purchase facility schemes and the motivation for them, Fisher said that the commercial paper (CP) market appeared one where the Bank could intervene "and so facilitate otherwise creditworthy firms in maintaining their access to short-term finance". The Bank's intervention appears to have contributed

Figure 2: UK GDP 1955-2010



to an improvement in conditions in this market. Similarly the corporate bond facility helped to reduce the liquidity premium in that market by improving the process of price discovery and offering a "backstop" bid in the secondary market.

Fisher told the Winter Paper audience that the commercial paper and corporate bond schemes seemed to "have been reasonably successful in helping to improve key markets and hence facilitating access to credit, at least for larger corporates".

These operations have been consistent with a central bank's function as the market maker of last resort. The evidence, in conjunction with the very large monetary stimulus at home and abroad, was that these corporate purchases have been "successful in helping to invigorate those corporate credit markets in which the Bank has intervened".

Box 1: The real economy

At the same time as the Bank of England asset purchase policy was being announced, output in the UK economy was dropping sharply. GDP fell by 6% overall during the recession and by 2.5% in the first quarter of 2009 alone when the policies were being enacted. This was the largest recorded quarterly fall in output since 1958 (see Figure 2).

Peter Williams is editor of The Treasurer.
editor@treasurers.org