

# Bank of England is not doing ‘monetary financing’

Andrew  
Bailey

**T**his is a time of great uncertainty. The Bank of England is doing all it can in this difficult environment to reduce the disruptive consequences for businesses and households and minimise longer-term damage to the economy.

To that end, the Monetary Policy Committee voted last month to increase the bank’s bond holdings by £200bn to support the needs of the British people. Some external commentators are linking this move to fears that it that it may be using “monetary financing”, a permanent expansion of the central bank balance sheet with the aim of funding the government.

This type of reserve creation has been linked in other countries to runaway inflation. That is because it could

undermine a central bank’s ability to control monetary conditions over the medium term. Using monetary financing would damage credibility on controlling inflation by eroding operational independence. It would also ultimately result in an unsustainable central bank balance sheet and is incompatible with the pursuit of an inflation target by an independent central bank.

But the UK’s institutional safeguards rule out this approach. Britain benefits from a strong institutional framework that allows the government and BoE to work together to provide economic support in ways that deliver longer-term stability and control of inflation. In monetary policy, that framework has several important elements.

The law requires the MPC to deliver price stability, which is defined through an annual inflation target of 2 per cent. The committee has a degree of flexibility in achieving this goal and must explain itself if the target is not achieved. The MPC has clear operational independence over how the inflation target is achieved. Each member is

individually accountable to parliament.

Our framework also recognises that the effects of monetary policy on the real economy are ultimately temporary. Monetary policy cannot increase output above potential in the long term and any systematic attempt to do so would raise inflation expectations, threatening the 2 per cent target.

---

## Reserves are not being created with the aim of paying for the government deficit

The MPC controls the level of benchmark interest rates and can vary the quantity of central bank reserves. Central bank reserves are interest-bearing deposit accounts held at the BoE backed by the central bank’s assets, mainly gilts.

Some MPC actions result in the creation of central bank reserves. But these reserves are not being created with the

aim of paying for the government deficit, as under monetary financing. They are a consequence of independent central bank policy actions to deliver monetary and financial stability.

In the UK, central bank reserves are created as a consequence of two broad categories of action.

The first type is when we undertake liquidity provision operations which are too short term to have an enduring influence on monetary conditions, but nonetheless have a short-term effect on the money supply. Examples of these include our recent provision of liquidity to the banking sector and purchase of commercial paper in the new Covid Corporate Financing Facility.

The BoE also works with the Treasury to support the orderly functioning of the gilt and money markets. Short-term operations play an important role in stabilising market conditions and counteracting any immediate tightening of monetary conditions.

These have only a very temporary effect on monetary conditions and are not primarily tools that can be used to

achieve the inflation target in the medium term.

We also create reserves when we undertake operations that are also temporary but are designed to have an impact on monetary conditions in the medium term. Quantitative easing, where the BoE buys bonds, is one example. QE increases bond prices and therefore reduces yields, which in turn lowers borrowing costs and support spending.

The crucial point is that the MPC remains in full control of how and when that expansion is ultimately unwound. The goal is to ensure that borrowing costs and spending are consistent with achieving the inflation target. If the recent expansion of bond buying appears to threaten that goal, the MPC can react.

The BoE will not hesitate to take all necessary actions both to support British businesses and households through this period of uncertainty and to ensure inflation is consistent with the 2 per cent target in the medium term.

*The writer is Bank of England governor*