

Analysis

Monetary policy and the value of the public debt

- Pressure is set to mount on governments to start to reduce their national debt
- Yet paradoxically US and UK post-crisis monetary policy practice stands to increase it
- Changes in the operating procedures of these two central banks seem likely
- One way could be sterilisation of some QE-generated commercial bank excess reserves

The national debt is set to come back into focus

Pressures will mount to bear down on public debt

The scale of government borrowing driven by the COVID-19 pandemic is leading to concern, vociferous already on the part of some investors, about countries' burgeoning public debt. In the US that debt has reached nearly \$28 tr,¹ or 130% of GDP; in the UK it has already topped £2 tr, some 100% of annual GDP.

Following the 2008 Global Financial Crisis (GFC), all major governments undertook large fiscal expansions – of the order of 2% of GDP. This fiscal expansion initially received little criticism, even in conservative quarters: but, after a couple of years, mounting disapproval led governments to start to retrench, leaving it to monetary policy to continue to support aggregate demand.

Similarly, when the COVID-19 pandemic hit, leading governments to lock down their citizenry, pressure for further powerful fiscal action to support incomes of those prevented from working was scarcely questioned.

However, as economic recovery comes into view, pressure will doubtless mount to halt the rise, and quite likely to reverse, the build-up of government debt. It will be important, this time around, to avoid making the mistake, made after the GFC, of starting to tighten fiscal policy before recovery has firmly consolidated.

A paradox

But new methods of monetary control will work against this

Given this it is therefore paradoxical that, in both the US and the UK, one consequence of the particular way in which those countries' monetary authorities came to conduct monetary policy over the post-2008 period, stands, as recovery consolidates, to make the public debt *bigger*.

This arises because:

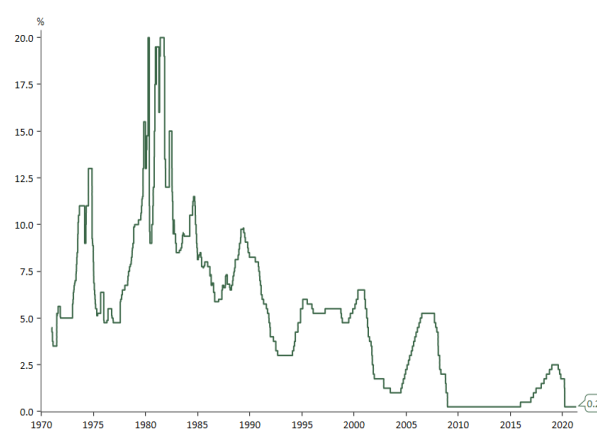
1. The bond purchases made by the Fed and the Bank under QE have swollen the reserves of the commercial banks;
2. These reserves are necessarily deposited with the central banks; and
3. As a means of controlling interest rates and thereby the amount of bank lending, the Fed and the Bank pay interest on these reserves.²

Figure 1: US reserve balances



Source: Federal Reserve Bank of St. Louis and Llewellyn Consulting

Figure 2: US Federal fund target rate



Source: Macrobond and Llewellyn Consulting

That is all very well when interest rates are near zero and the reserves are low. But the reserves are not low – they amount to around \$ 4 tr in the US, and £800 bn in the UK. And at some time in the future the Fed and the Bank will need to raise interest rates.

Monetary authorities will face two choices, both unpalatable

When they do they will face, under present policy arrangements, an unenviable choice: either sell some of their holdings of government debt– and thereby incur a loss, given that bond values fall as interest rates rise – or pay large sums to commercial banks in interest on these reserves, potentially amounting in the UK, for example, to tens of billions of pounds annually.³

Neither course is attractive. Moreover, there is no obligation to pay interest on these QE-created reserves. While commercial bank reserves are conventionally counted as a liability of the central bank, and hence as part of the public sector debt, the reserves are themselves ‘ultimate’ money, and cannot be repaid.

Moreover the banks are not doing the Fed or the Bank a favour in lodging their reserves with them: on the contrary, the central banks are rendering them a service by acting as clearer and lender of last resort.

The Fed and the Bank have paid interest purely pragmatically as a way of controlling short-term interest rates. But given the now-swollen reserves, a more economical way of influencing short term interest rates to discourage excess borrowing is required. This is not currently the focus of central banks’ attention; they are still concerned with allowing economic activity to recover, and are preoccupied with their lack of firepower to prevent another recession, given the already-minimal level of interest rates. However, as the balance of risks levels up and excess demand is seen to be a potential problem, the issue will become salient.

There is another option

Or they could require banks to hold Special Deposits

One option then would be for the central banks to sterilise reserves in the system by requiring deposit-taking institutions to hold Special Deposits with them at zero interest. This would enable the Fed and the Bank, whenever they wished to restrain lending, to set higher interest rates only on ‘marginal’, or ‘borrowed’, reserves.

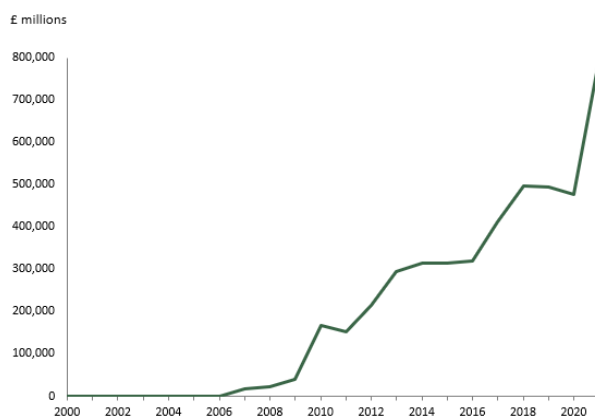
Such policy action would enable the Fed and the Bank to exert monetary control at a lower cost to the Exchequer. That said, executing the policy would not be straightforward;⁴ and there would be complaints. The commercial banks in particular could well be strident, with a claim that they were being taxed on ‘their’ reserves.

The commercial banks would doubtless complain ...

Moreover there would almost certainly also be criticism that such measures would encourage financial disintermediation and favour non-bank intermediaries and offshore lenders.

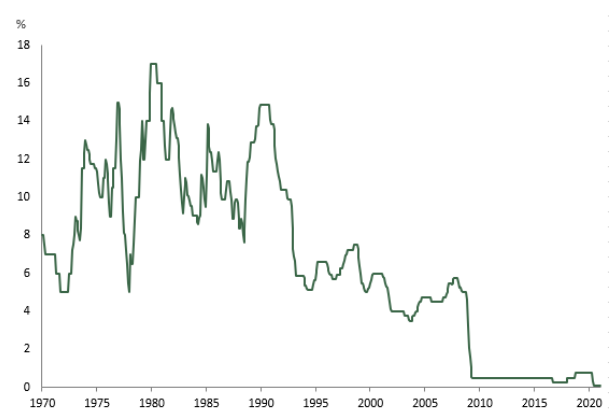
Practical difficulties notwithstanding, however, neither argument would seem decisive.

Figure 3: UK reserve balances



Source: Bank of England and Llewellyn Consulting
 Note: The reserve balance system was introduced in 2006. Before that banks' balances at the Bank of England were termed operational balances and did not pay interest.

Figure 4: UK base rate



Source: Bank of England and Llewellyn Consulting

Three arguments to consider

1. First, there is no evident reason, legal or moral, why the central banks should pay interest on those reserves. They came into being only because of central banks' QE operations.
2. Second, Special Deposits are 'lump sum' rather than a constant proportion of deposits, and so are less likely to push deposits out of the banking system. Anyway, they should be levied on all deposit-taking institutions, not just clearing banks. As regards the UK, for example, offshore lenders would be at an advantage only to the extent that their cost of sterling funds was lower than UK-based lenders, which is not necessarily the case.
3. Third, there is also concern that, in paying attention to how monetary policy affects the public finances, the central bank might compromise its independence. But both the Fed and the Bank managed to preserve their independence while making large-scale government bond purchases to combat deflation; surely they can maintain that credibility while enabling indebted governments to avoid paying too dearly for an eventual rise in interest rates.

... and central bank independence might be deemed at risk

But that does not seem convincing

Having an unquestioned and primary responsibility for inflation control should not preclude the central bank from co-operating on other objectives, provided that the policy priorities are clear and their responses are at their own discretion.

Watch fors⁵

- Public discourse starting about the budgetary implications of higher interest rates.
- Reconsideration by the Fed and the Bank of paying interest on commercial banks' reserves.
- Claims by the commercial banks that they are being penalised. ■

This paper is based on a paper by Gerald Hotham and published by the Policy Reform Group, a think tank established by Llewellyn Consulting and Gatehouse Advisory Partners – see Holtham, G., 2021. *Monetary Policy and the Value of Public Debt*. Available at [Policy Reform Group - Monetary policy and the value of Public Debt](#)

Helpful comments on an initial draft of this paper were given by, amongst others, Philip Turner, Russell Jones, John Nugée, Han de Jong, and Michael Heise.

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¹ Source: U.S. Department of the Treasury. Fiscal Service, Federal Debt: Total Public Debt [GFDEBTN], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/GFDEBTN>, [Accessed 16 April 2021]

² The Federal Reserve Bank of St Louis explains the matter thus:

“Interest on Reserves is the newest and most frequently used tool given to the Fed by Congress after the Financial Crisis of 2007-2009. Interest on reserves is paid on excess reserves held at Reserve Banks. Remember that the Fed requires banks to hold a percentage of their deposits on reserve. In addition to these reserves banks often hold extra funds on reserve. The current policy of paying interest on reserves allows the Fed to use interest as a monetary policy tool to influence bank lending. For example, if the FOMC wanted to create a greater incentive for banks to lend their excess reserves, it could lower the interest rate it pays on excess reserves. Banks are more likely to lend money rather than hold it in reserve (so they can make more money), creating expansionary policy. In turn, if the FOMC wanted to create an incentive for banks to hold more excess reserves and decrease lending, the FOMC could increase the interest rate paid on reserves, which is contractionary policy. See Federal Reserve Bank of St Louis, 2021.”

How monetary policy works. [Online]. Available at [How Monetary Policy Works | In Plain English | St. Louis Fed](#) [Accessed 17 April 2021]

The Bank of England has behaved similarly since 2006. The Bank explains the matter thus:

“On 18 May 2006 the Bank of England introduced a range of reforms relating to its money market operations. As part of these reforms: i) A wide range of banks and building societies are able to hold a target level of voluntary reserve balances with the Bank. Each reserve account holder will undertake to meet this target, on average, over a maintenance period lasting from one scheduled MPC decision date to the day before the next ...”

See bank of England, 2006. *The implications of money market reform for data published in Monetary and Financial Statistics.* [Online] Available at [The implications of money market reform for data published in Monetary and Financial Statistics \(nationalarchives.gov.uk\)](#) [Accessed 18 April 2021]

³ In the United States there have already been discussions about raising short rates before withdrawal of QE, and the spectre of making large payments to commercial banks. See Board of Governors of the Federal Reserve System, 2021. *History of the FOMC's Policy Normalization Discussions and Communications.* Available at <https://www.federalreserve.gov/monetarypolicy/policy-normalization-discussions-communications-history.htm> [Accessed 10 January 2021]

⁴ For example, a Supplementary Special Deposits policy (the so-called ‘corset’) to constrain bank lending was deployed three times in the UK in the 1970s. For a full description and assessment, see Bank of England, 1982. *The supplementary special deposits scheme.* Bank of England Quarterly Bulletin, March. Available at [QB 1982 Q1 pp74-85 \(bankofengland.co.uk\)](#) [Accessed 18 April 2021]

⁵ It should be incumbent on any analyst or forecaster to indicate what circumstances, were they to eventuate, would call into question the forecast or expectation, or, more fundamentally, the understanding on which these were made. Moreover, in deciding which data should be asked to bear the greatest weight, it is important to minimise the risk of Kahneman ‘confirmation bias’ – selecting the data that best support the case being made. In our ‘Watch Fors’ we make clear what data, were they to eventuate, would in our judgement invalidate our forecast or expectation.

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