The IMF queries Bank of England policy

In an interesting recent IMF blog three senior officials advise Central Banks on how to balance counter inflation policy with the need to avoid problems with banks and non bank financial institutions.

They look at how UK pension funds and liability driven investment strategies revealed “the perilous interplay of leverage, liquidity risk and inter connectedness”. They query how a Central Bank injecting liquidity to ease such a situation could complicate the fight against inflation. They propose three types of permitted intervention. Discretionary market wide intervention targeted to segments at risk. Lender of last resort loans. Standing loan facilities for non bank financial institutions in need.

They go on to stress “Clear communication is critical, so that liquidity support is not perceived to be working at cross purposes with monetary policy. For example, purchasing assets to restore stability while continuing with quantitative tightening to bring inflation back to target may cloud intent and complicate communication. “ Yet this is what the Bank of England tried over LDI.

This is what the Bank of England did. They deliberately drove bond prices down by announcing and commencing a large bond sale programme. This led to big losses in pension funds, and more calls for cash on the geared positions in government bonds LDI funds were running. LDI funds then also sold bonds to meet calls making their positions worse and increasing the losses. The Bank then bought up some bonds to reverse some of the price falls it had helped create.

The truth is the Fed and the Bank of England printed too much money and kept rates too low in 2021.In the last year they rushed to tighten, causing tremors in UK pension funds and some US regional banks. When financial instability appeared they both eased by supplying money to markets offsetting the severe Quantitative tightening they were still executing. They should both take money and credit growth more seriously and stop lurching from too easy to too tight.

It is strange the leading western Central banks all thought they could create money and buy bonds at ever higher prices to ease conditions without it causing inflation. They were wrong. Now they think they can sell bonds at ever lower prices, tightening money and drying up liquidity without it causing any problems amongst banks, pension funds and other large holders of bonds. Why?