Discussion of

Liquidity Management and Central Bank Strength: Bank of England Operations Reloaded, 1889-1910

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Big Picture

- Credibility is key to central bank operations
- Considerable recent interest in how central bank credibility is related to their balance sheets.
  - Size and leverage have increased substantially in recent years
  - Increased risk of losses due to credit risk and interest rate risk
- Concern that too much leverage reduces credibility
- This paper argues that an inability to increase size/leverage impaired credibility and operational effectiveness of the BoE

Argument put forth in this paper

- Several reasons to think the BoE's ability to implement policy may have been impaired
- BoE was constrained in its ability to expand
  - Limits on note issuance, barriers to raising capital
  - Becomes smaller relative to markets and commercial banks
- Lacked tools that would have made policy implementation easier
  - No ability to pay interest on deposits
  - No liquidity/reserve requirements to create captive demand for liquidity

Evidence for impairment

- Normal times
  - Interest rate volatility is relatively high
  - Close to reaching some balance sheet limits for implementing typical operations
- Crisis times
  - Unusual policies in response to Barings crisis
  - Appears unable to deal with the crisis surrounding onset of war in 1914.

Point 1: Evaluating policy effectiveness

- Need to describe BoE's policy goals and operating targets
  - Exchange rate and capital/gold flows?
  - Interest rates? Long-term or short-term?
- If the exchange rate and capital flows were the policy target, then volatility in interest rates could simply been a consequence of implementing policies to hit those targets.

Point 1 continued

- More importantly, knowing what the policy goal was points to where to look to see whether policy was becoming less effective.
  - Could look at deviations from targets (interest rates or exchange rates hitting gold points).
  - Could look at the size of operations required to move markets back to target (caveat: scaling these correctly is challenging)
  - Both indicate the amount of control by the central bank
- Hypothesis of the paper is that deviations and/or required policy actions should become larger over time.

Point 2: Communication

- Currently we view communication as facilitating policy by shaping expectations
  - Requires smaller operations
- This openness is a recent development
  - But previously market participants watched, guessed, and took cues.
- Curious about communication by the BoE
  - Market participants had some knowledge of what it was doing.
  - Did they guess at its intentions? Was there an impact on policy?

Point 3: Crises/LoLR

- Random musings:
- Crises are times when credibility matters most
  - If LoLR is really credible, then in many situations, there won't be a crisis…
- Was the BoE's solvency a serious concern?
  - Given that the BoE was strongly connected to the government, would it have been credible for the government not to support the Bank?
- Crises always call for extraordinary action
  - Such actions don't necessarily indicate that the strength or credibility of the LoLR is impaired.

Point 3 continued

- International comparisons would be insightful
- During other stress episodes
  - There were periods of crisis elsewhere during the sample period. (Some in 1897 and 1901. 1907 was a rather bad year)
  - How did the UK fare relative to:
    - Countries in crises
    - Countries “close to” countries in crises
- Was the nature of the WWI crisis different?
  - Not a standard crisis (where some, possibly over-levered, institutions face concerns about insolvency and illiquidity).
  - Again cross country comparisons would be informative