Funding the Future

How are the central bank reserve accounts created?

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I have been asked to explain how the central bank reserve accounts held by the commercial banks with the Bank of England are created. This note seeks to do that.

First, note that central bank reserve accounts (CBRAs) are held by the UK's commercial banks with the UK's central bank – the Bank of England.

As a central bank the Bank of England is owned by the UK government. It is responsible for the day-to-day management of the money supply in the UK; for the regulation of commercial banks in the UK and for managing the settlement of inter-bank debts in sterling, for the issue of which currency it is responsible.

The central bank reserve accounts serve two purposes. Firstly, they provide the mechanism by which payments from commercial banks and their customers are made to and from the government. Secondly, they are the mechanism used by commercial banks to make settlement of the liabilities that they owe each other when fulfilling the obligations that their customers request be settled with customers of another bank.

These accounts are as a result restricted for the use of commercial banks and some other regulated entities in the financial services industry. It is believed that there are only a few hundred of them as a result.

Second, note that before 2007 there were almost no such balances, at least in total. The commercial banks and the Bank of England sought to achieve this result each day but used other very short-term overdraft and loan arrangements if that was not possible at that time. The current situation where all CBRAs are, in effect, bank despot accounts held by the UK's commercial banks as a mechanism to guarantee their ability to make settlement to each other is almost entirely a creation of the post 2008 global financial crisis as a result.

Third, note that this change was in no small part motivated by those banks refusal to trust each other to make settlement after 2007, in which year it became clear that major commercial banks could fail when none had effectively done so since the 1860s.

Once banks had demonstrated their own inability to manage their balance sheets at the time of the global financial crisis it became apparent that these banks would need to hold funds with the Bank of England to prove their ability to fulfil their own promises to pay.

Fourth, the central bank reserve accounts were, in my opinion, deliberately boosted in value by the Bank of England to facilitate this inter-bank payment process. This was the way in which banks were bailed out post-2008 to prevent them failing again.

In that case the way in which these reserve accounts have been increased in value needs to be noted. Doing so requires four things to be understood:

* Overall, the sum held on these accounts is not within the control of the commercial banks. The sum that each bank might hold will vary from day to day. However, that is the consequence of payments between banks varying. However, the quantum of funds held in the CBRAs as a whole is determined by the Bank of England on behalf of the government because it is the sole creator of what is called ‘base money’.

* ‘Base money’ is sometimes called ‘central bank money’. It comprises the currency issued by central banks in the form of notes and coins plus the balances on the CBRAs.

* Base money is created as a result of the CBRAs being used to transfer funds from the Bank of England into commercial banks on behalf of the government, to whom it acts as primary banker through the Consolidated Fund, and to also receive payments from those banks that are due to the government.

* In summary, payments from the Bank of England Consolidated Fund account to the commercial banks increases the sums held in the central bank reserve accounts and so create what is called base money. These payments are made in the ordinary course of government business to make settlement to whomsoever the government chooses to make payment to, from an old age pensioner to the sums used to redeem gilts when they reached their repayment date. Payments to the government via the CBRAs include taxes due, the proceeds of new gilt issues and the receipt of the many trading sums owed to government agencies.

In that case the only way in which the balances on the central bank reserve accounts can increase is by the government spending more into the economy than it receives back from it. There is no other way in which this can happen. In turn that is only possible because the government can decide to fund its expenditure with new money created on its behalf by the Bank of England. That new money that the Bank of England creates for the government is base money.

The corollary is also true. The only way in which the balances on the CBRAs can be reduced is by the government collecting more money from the commercial banking system than it spends into the economy e.g., as a consequence of taxes paid being in excess of government expenditure, or by raising new borrowing in excess of current requirements e.g. because of quantitative tightening.

In this context, the role of quantitative easing can appear to be confusing, although it is actually quite straightforward. The pattern is as follows:

* At any time it wishes the government can decide to issue now financial instruments. These can be very short term, in which case they are described as Treasury Bills and are redeemed in days. Alternatively, they can issue bonds or gilts, which can have duration from a year or so to fifty years or more. It has been government practice to only issue such bonds when there is a deficit on its Consolidated Fund account with the Bank of England, the aim being to restore a neutral balance on that account. This, however, is not a necessity and before 2008 it was commonplace for this account to also be cleared through the so-called Ways and Means Account that the government maintained with the Bank of England, which was an overdraft in all but name.

* The issue of new financial instruments, of whatever their nature, results in new financial flows from the commercial banks to the government either because the banks themselves buy these instruments or, more commonly, because their customers do. These flows move through the CBRAs in either case since this financial conduit to and from the government is only available to the banking sector and a very select limited number of other financial services sector entities. Whether the payment the commercial bank makes is as principal or agent for their customer makes no difference: the flow is from them to the government via the central bank reserve accounts. The result of the issue of new bonds is to reduce the balance in the CBRAs, meaning that the balances on those accounts created by government spending being in excess of routine income are cancelled in whole or part. Bond issuance of this sort, it is stressed, is not a part of the quantitative easing process.

* If the Bank of England then decides to undertake quantitative easing all that it does is lend funds to its legal subsidiary, the Bank of England Asset Purchase Facility Fund Limited (the 'APF'). This company is fully indemnified with regard to its activities by HM Treasury and as such an agent of Treasury and is not under the effective control of the Bank. That company then uses the loan funds provided to it by the Bank of England to buy bonds issued by HM Treasury on the open financial markets. There is no reason why these bonds need to be owned by the commercial banks, and it is likely that most of them will not be. This is inconsequential to the resulting movement through the central bank reserve accounts, which is represented by a flow of funds from the account of the APF to the commercial banks, which as a result increases the central bank reserve accounts balances.

* As a result bond issues cancel the CBRAs created by government spending being in excess of government income, and QE then in turn cancels that process, as if the bond issue never took place., effectively restoring the CBRA balances created by expenditure exceeding income. Given that the bond that was issued is, after being repurchased using QE under the effective ownership and control of HM Treasury it is easy to argue that the bond in question has effectvely been cancelled. This is the accounting position reflected in the Whole of Government Accounts, which are the only true and fair accounting representation of this transaction[1].

* QE is then a simple way of swapping bonds that need never have been issued for base money, and QT reverses that swap.

As a result the reality is that QE and QT are window dressing and it is the excess of government spending over income and routine bond issuance since 2008 that has created the CBRA balances.

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[1] https://www.gov.uk/government/collections/whole-of-government-accounts