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Bank of England Faces Pressure to Rethink Quantitative Tightening Strategy

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The Bank of England (BoE) is under scrutiny as it prepares to review its quantitative tightening (QT) programme, with expectations mounting that it will scale back the pace of shrinking its £558 billion government bond holdings. Economists and market analysts are keenly awaiting the BoE's August 7 policy statement, which will evaluate the past year's QT efforts and set the stage for decisions in September on bond sales for the next 12 months.

With bond market volatility, rising yields, and political criticism over losses incurred from sales, the central bank faces a delicate balancing act.

Over the past year, the BoE has reduced its gilt holdings by £100 billion, with £13 billion sold through auctions and £87 billion allowed to mature. Maintaining this pace would require a record £51 billion in active sales over the next year due to fewer maturities. However, market conditions have shifted significantly since the BoE last sold nearly £50 billion of gilts in the year to September 2024. Peter Schaffrik, global macro strategist at RBC, highlighted the challenge, stating in a recent interview, “The market would likely react poorly if they pushed ahead with such a large sale volume.” He noted that the BoE’s view of QT as a background operation is increasingly untenable given the heightened attention it now attracts.

Unlike other major central banks, the BoE’s QT approach combines active bond sales with allowing holdings to mature naturally. Yet, recent bond market turbulence, including 30-year gilt yields reaching their highest since 1998 in April following global trade disruptions, has raised concerns. The yield curve has also steepened, with the gap between five- and 30-year gilt yields doubling to 1.4 percentage points, and the 2/10-year curve rising to 0.75 points from near zero. These shifts have sparked debate about the impact of QT in a falling interest rate environment. Dani Stoilova, Europe economist at BNP Paribas, argued in a recent analysis that halting gilt sales from October could prevent further market disruption, given the untested dynamics of active QT alongside rate cuts.

BoE Governor Andrew Bailey has dismissed claims that QT is driving up borrowing costs, stating last week, “We need to examine the interplay between yield curve movements, QT, and market functioning, but QT isn’t the primary culprit.” Nevertheless, former Monetary Policy Committee member Michael Saunders suggested the BoE might pivot to selling shorter-dated gilts or pause sales of those with maturities of 20 years or more. Adam Dent, chief U.K. rates strategist at Santander CIB, cautioned that QT’s influence on yield curve steepness is minimal, adding, “Using QT to control the curve’s slope would likely have little lasting impact.”

The BoE’s long-term QT goals remain opaque. One initial rationale for QT was to reduce banks’ excess reserves, currently at £680 billion, towards a “preferred minimum” range of £385–540 billion, as estimated by bankers. However, growing use of the BoE’s repo operations suggests this floor may be closer than anticipated. Schaffrik noted, “The BoE might slow QT to feel its way towards that level, but they’ve given no clear indication of their

ideal target.” With reserves approaching this threshold, the BoE may continue sales for financial stability reasons, potentially requiring banks to rely more on repos.

As the Labour government faces criticism for economic management, the BoE’s handling of QT losses has drawn political ire, adding pressure to tread carefully. The central bank’s next steps will be closely watched, not only for their immediate market impact but also for what they signal about navigating an increasingly complex economic landscape.