

What happens if the proverbial hits the fan this time?

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The mood in the financial press is sombre this morning. From the possibility of a major downturn being the view of a few Cassandra (like me) it is now becoming widespread. Martin Wolf does, for example, now appear resigned to it.

For the record, I do not think we are facing an October 2008 scenario soon. Or maybe at all this year. But then, no one did at the beginning of 2008. I expected a crisis then, but not a crash of the sort that happened. And I expect a crisis now, but I hope not a crash. But what happens if I (and most people) are wrong. Suppose some unforeseen event, such as a major currency realignment, leaves massive exposure in the world's banks or hedge funds that means derivative contracts fail in a big way leading to an immediate liquidity crisis (the thing we always have to fear most) akin to October 2008? What then? I think we do have to think about it because we cannot afford to repeat the mistakes of last time.

Let's be clear what they were. In no particular order I would suggest they were unpreparedness; panic in the face of potential bank runs with no plan for containing the demand for liquidity that resulted in massively unwise bank guarantees in some cases; over paying for crippled financial institutions; failure to stop some particularly harmful forms of trading in a downturn and inability to deal with the aftermath. I will ignore the last for now. Let me look at the rest.

First, I hope someone has done some serious contingency planning this time. Second, hope against hope that someone has had the wisdom to print a lot of £100 and £1,000 notes that can be time limited in circulation. This is the big innovation I suggest to deal with panic. What do I mean by it? Simply that if anyone really fancies staging a run on a bank I suggest that notes be made available so that they can be paid in cash without having to offer the type of bank guarantees that crippled Ireland. And time delimited notes mean that they have to be deposited again within, say, a month when order has been re-established. And if they are not they are cancelled so that they cannot be used for crime. Their deposit in a bank outside the UK should also be barred: no bank should be able to claim settlement on them if they are. I am not sure such a technique has been tried before, but so what? What is required is short term liquidity. But the demand for short term liquidity should not create a long term difficulty as it did in 2008. Time delimited bank notes meet that need: the government will promise to

pay, but only for a limited period after which redepositing has to occur. Confidence in being able to extract money from an institution is established. The demand for cash is then likely to fall. And the crisis has to pass in a short period.

In the meantime, and third, I hope security is planned for cash points.

And fourth, that plans for emergency legislation for the immediate, no compensation, nationalisation of any bank in trouble exist: we can't be caught paying for failed banks again.

Fifth, legislation to stop capital flight must be passed: tax withholding at an emergency rate would be appropriate. This might be variable to match demand: the rate would rise if demand increased. This would not apply to settlement of trade liabilities.

Sixth, emergency credit to ensure businesses unable to meet UK liabilities because of non-payment in other currencies must be made available. This could be by way of tax deferral. If that is insufficient facilities must be made available from a National Investment Bank. If not repaid within six months these should be convertible into equity stakes in the businesses supported. The National Investment Bank must be supported by People's QE. If the Maastricht conditions need to be ignored for timeliness, so be it. Seventh, certain types of stock trading should be suspended. Stock lending should be barred. Short selling would also need to be barred. And if in consequence derivative positions are incapable of settlement emergency clearance should be arranged so that compensation in terms of margins made or lost could be settled instead of principal sums, where possible (although I stress, this idea needs development and is not my area of greatest expertise, and I admit it). The risks inherent in seeking to resolve such situations are noted to be high: any institution requiring emergency funding as a result would be subject to automatic nationalisation without compensation. Directors of such institutions would face unlimited liability with regard to losses.

Eighth, emergency legislation with substantial criminal and asset confiscation penalties must be passed to prevent anyone seeking to profit from trades with a regulated financial institution of any sort requiring emergency funding. This would also apply to non-financial institutions applying for emergency credit to survive.

Ninth, politically bi-partisan solutions should be sought. A government elected without a mandate for action in this situation cannot govern during it without the involvement of other parties.

Tenth, communication is key. It must be made clear money is and will be available, come what may. Governments can and must print money in these situations until calm is restored.

Are these sufficient conditions for survival? No, probably not. Are there obvious problem areas? Yes, in derivatives most of all: Lehman took years to unwind. But the key point is any crisis will always be about liquidity and this time this must be provided in ways that impose least long term cost that by definition require reversal (hence time limited notes) and where the state takes control without being burdened with a debt obligation to those who should bear the real cost of the failure of the institutions in which they had invested, even if it was only a short term liquidity crisis that induced it.

And, of course, I accept that what I have written is not comprehensive. I am simply suggesting directions of travel to help curtail the risk if we do have another crisis. So please don't nit pick detail and stick to fundamentals. There are enough of those here to chew on.

(Please also note I am in meetings all day in Copenhagen; moderation may take a while).