Funding the Future

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There are moments when it is wise to think a reconsideration is appropriate. My suggestion for perpetual debt did not go down well yesterday. But it did create invaluable debate. Even 100-year debt was not seen as a zinger. But long term debt at near enough zero per cent as a way of locking in rates on money seemed to be acceptable.

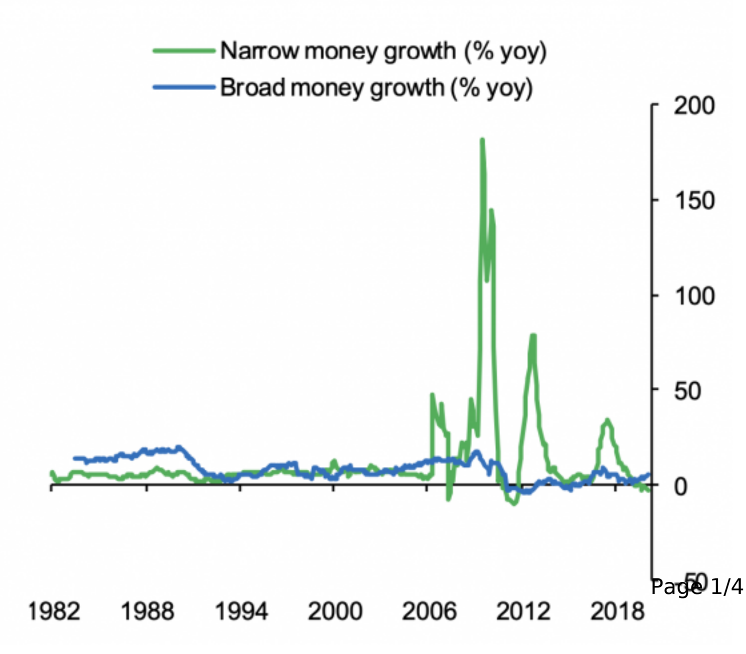
Let's be clear what money I am talking about. It is the central reserve account balances held by the UK's banks and building societies with the Bank of England. These balances are described by the Bank of England as follows:

We are the UK’s central bank. Our balance sheet is special for one key reason — the nature of our liabilities. Central bank money, whether in the form of banknotes or central bank ‘reserves’ (deposits held with us by financial institutions), provides the ultimate means of settlement for all sterling payments in the economy.

This gives our balance sheet a central role in supporting monetary and financial stability.

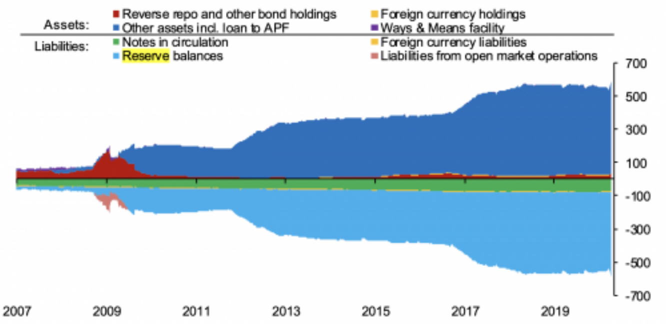
These balances are, then, money par excellence. And those who claim that they are broad money are wrong - the Bank of England says so. In this context, note this from a speech from Monetary Policy Committee member Gertjan Vlieghe in April this year:

Figure 2: UK money growth



Narrow money goes up with every QE issue. That is because QE creates central bank reserve accounts. And they are narrow money. This is reflected in this representation of what is claimed to be the Bank of England balance sheet from the same speech:

Figure 1: Bank of England balance sheet (GBP billions)



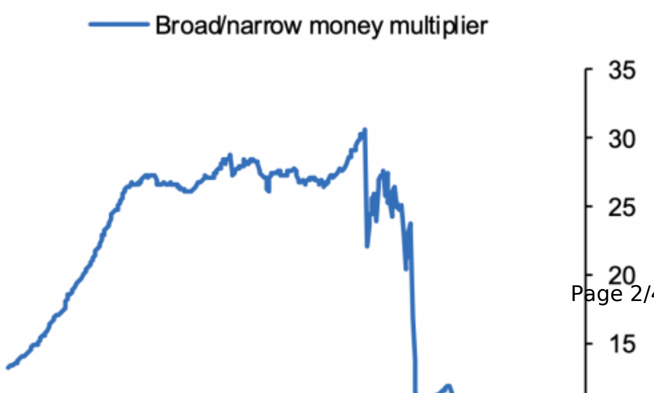
Source: Bank of England Weekly Report. Latest observation: 14 April 2020.

I say 'claimed to be' for a reason: no such balance sheet is ever actually published because this consolidates the Asset Purchase Facility (APF) notionally is run by the Bank of England and which actually legally owns the repurchased gilts into the Bank of England accounts but for actual accounting purposes that cannot be done as the APF is under the control of HM Treasury: although technically a subsidiary of the Bank of England its accounts are not consolidated for this reason. The above is then a Bank of England / Treasury balance sheet, but the point remains the same. As QE rises, so too (near enough, but not precisely) do central bank reserve accounts with the UK's banks and building societies increase.

For those confused by this, and who wonder what they do with this 'money', please remember what money is: it is simply a debt. There is no physical moving of assets here. And remember that no money is reused in banking. Bank money is simply a record of a debt. The APF has bought gilts from banks using money created out of thin air for that purpose by the Bank of England and that debt remains outstanding to the banks. There has been nothing to redeem it. At present there is about £800bn still, in effect owing, to be cancelled either by tax or new debt sales by HM Treasury, which is all that these balances of central bank money can effectively be used for.

In the meantime, those balances sit as deposits on commercial bank balance sheets. This is from the same speech byGertjan Vlieghe:

Figure 3: Money multiplier



In 2006 for every pound of central bank money (broadly cash back then, because central bank reserve accounts were out of fashion then and banks extended each other credit, which they no longer do) there were roughly £30 of commercial loans. This is where the claim that private banks make the vast majority of money came from.

By April 2020 that ratio was £5 of bank loan for every pound of central bank money. That ratio will now have fallen again: there has been £200 billion more of QE since then.

So, let's be clear about three things.

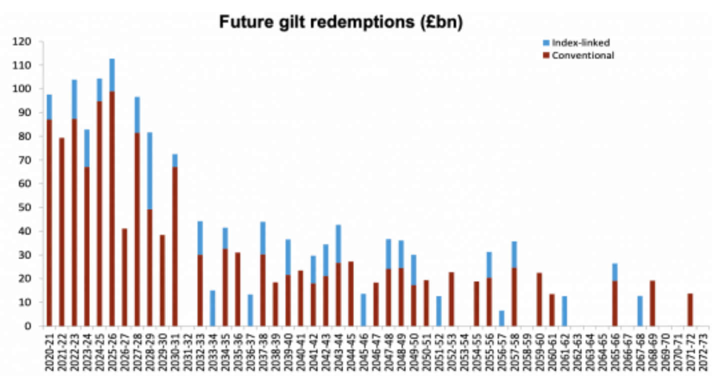
First, private banks do not lend their central bank reserve balances on. They create new money when they lend.

Second, there would appear to be more central bank reserve balances than are needed for normal purposes at present (but the March 2020 market freeze was a warning shot on the need to have sums available to ensure liquidity between commercial banks; that was why £200 billion of QE was created then).

Third, if there are, on a day to day basis excess central bank reserves, and that seems to be the case given this loan to narrow money ratio, then the question that I ask about what can be done to manage this issue when the Bank of England thinks it necessary to control rates by paying interest on these balances does seem a fair one.

So, let me retreat from perpetuals. I know when I am beaten (even if part of narrow money is, of course, zero rate perpetuals - because that is what notes are).

And let's talk no more than 100 years. Just to put this in context the Debt Management Office suggests current debt profile is as follows:



There is already long-dated debt, as will be noted

But what we have in the case of the relationship between the Bank of England and banks with regard to central bank reserves is something different. The banks have an asset that they did not choose to acquire, but had little choice but have imposed upon them in their role as intermediaries. And as is apparent, this asset is not, as such used in their business except for the purposes of inter-bank settlement, as the Bank of England has noted.

So the question to ask is can the risk to the Bank of England on interest cost be hedged? That is what my video yesterday was effectively asking. My suggestion remains that it can be. First, that is by recognising that these balances are narrow and not broad money. Second, it is by recognising that whilst narrow money is important its use is limited. And third, it can be by accepting that the amount of that narrow money that need be in issue with a variable interest rate need not be the full value of the balances now held. I am not sure that any of these suggestions should be that contentious.

So what to do? Let's stick with the need for some of these central reserves to continue as now. And let's then suggest that a form of long term debt that is tradeable between the holders of these balances and the Bank of England alone is an alternative for the remaining balances. In other words, it remains a means of settlement. It remains narrow money, in effect. That is only possible with a very long redemption date. And let's suggest that a fixed rate is appropriate on this money. The average cost of government debt right now is 0.3%, which if it was used for these excess balances would add an immaterial £1.6 billion at most to the cost of serving the national debt, and provide banks with a rational reason to opt into such issues now.

Is that viable? I stress, I am exploring ideas. And I think this restructuring of what looks to be an unsustainable balance sheet as to form, but nonetheless necessary balance sheet as to function is necessary and that is why I am exploring this.