

Sunak needn't have a debt crisis if he simply to...

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I am sharing this press release from an organisation called the Policy Reform Group, of which I admit I know little.

The [release refers to a paper](#) by Gerald Holtham, who is Hodge Professor of Regional Economy at Cardiff Metropolitan University, Managing Partner at Cadwyn Capital, and an Associate of Llewellyn Consulting. Prior to that Professor Holtham was a Fellow of Magdalen College, Oxford, Chief Investment Officer at Morley Fund Management, Director of the Institute of Public Policy Research, Chief Economist at Lehman Brothers, and Head of the General Economics Division in the OECD Economics Directorate.

He has this to say:

Government borrowing driven by the COVID-19 pandemic is leading to increasing concern about the growing size of the UK public debt, which topped £2 tr — some 100 per cent of annual GDP — by the end of the fiscal year 2020-21. This brings two issues into focus.

First, with one-third of unexpired UK government bonds currently in the hands of the Bank of England following its purchases under the policy of Quantitative Easing (QE), this portion of government borrowing is a contingent liability rather than straight debt. It is unlikely that much of it will ever be 'reissued'.

Second, and even more importantly, the particular way that the Bank of England currently conducts monetary policy stands to make the operation of monetary policy unnecessarily 'costly' in budgetary terms. This is because bond purchases made by the Bank under QE swell reserves of the commercial banks which are held with the Bank of England.

The Bank pays interest on these reserves as a means of controlling interest rates and thereby the amount of bank lending. And that is all very well when reserves are low or when, as at present, interest rates are near-zero.

However, that will not always be the case. At some time in the future the Bank will need

to raise interest rates. And then it will face a choice: either sell UK government debt holdings — and thereby incur a loss, given that bond values fall as interest rates rise — or pay large sums to commercial banks in interest on these reserves.

Neither course is attractive; and nor is it evident why the Bank should pay interest on these QE-created reserves. While commercial bank reserves are conventionally counted as a liability of the Bank of England, and hence as part of the public sector debt, the reserves are themselves ‘ultimate’ money, and cannot be repaid. Moreover the banks are not doing the Bank of England a favour in lodging their reserves with it: on the contrary, it is rendering them a service by acting as clearer and lender of last resort. There is therefore no reason, legal or moral, why it should pay interest on those reserves. It has done so purely pragmatically as a way of controlling short-term interest rates. But given the now-swollen reserves, a more economical way of influencing short term interest rates to discourage excess borrowing is required.

There is another option. The Bank could sterilise reserves in the system by requiring deposit-taking institutions to make Special Deposits with it at zero interest. This would enable the Bank to set higher interest rates only on marginal, or borrowed, reserves in order to restrain lending. The contingent value of the public sector debt — netting out the authorities’ own holding — would then not be 100 per cent of GDP, but more like 70 per cent.

Such policy action would also enable the Bank — without prejudice to its monetary policy independence — to exert monetary control at a lower cost to the Exchequer. The Bank managed to preserve its independence while making large-scale government bond purchases to combat deflation; surely it can maintain that credibility while enabling an indebted government to avoid paying too dearly for an eventual rise in interest rates.

I quote this release because I agree with it. I have long been confused as to why the Bank of England feels itself obliged to pay base rate on the central bank reserve accounts that it has, in effect, created for the UK’s clearing banks.

These supposed deposits simply represent the debt owing to the banks for the funds used to repurchase government bonds under the QE programme. The clearing banks can only use them to make payment to the Bank of England, for example when settling tax liabilities due from their customers, or to pay another bank when clearing customer liabilities. The reality is that this only requires balances totalling a few tens of billions, as was the case in 2008 before QE. The rest has been forced on the banks.

Why then pay base rate on them? Simply because before 2008 the balances were so small it did not matter and since then the interest rate has been so small again it did not matter. Near enough £800 billion is held on these accounts now, at an annual cost of £800 million, which in government funding terms is not great (but is, apparently, [when allocating funds to pay for children’s education](#)).

The concern the Treasury has is that if interest rates rose to say 2 per cent (which would be enough to probably precipitate a major personal debt crisis in the UK) then the cost of serving these central bank reserve accounts might become £16 billion a year - enough to pay for all the catch up education required in the UK.

Sunak is obviously now holding back the money needed for children's education to pay this interest cost to keep banks happy.

But I entirely agree with Prof Holtham that this is completely unnecessary. Simply redesignate the sums as special deposits and require that the banks hold them (which the Bank of England has the power to do, and which it has done in the past) and then pay zero interest rate on them and the problem of interest rate costs is solved.

What is more, effective government debt is reduced by more than 30%.

And maybe £16bn of cost is saved if rates rise by a lot. Enough, then, to cover the cost of children's education, in fact.

And what is more, there is no need for austerity anymore as the debt crisis has been solved (not that there was a debt crisis, or need for austerity, but let's beat them using their own narrative).

In other words, Sunak has no debt problems left, at all.

If he claims he has then he is not telling the truth. And to do that to impose real loss on the children of the UK, to prefer banks instead, would be unforgivable. But that is what he seems to be doing.