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I have had a number of people draw my attention to an article by the National Institute for Economic and Social Research (NIESR) in which they claim:

The proposal to reduce public spending by ceasing immediately to pay commercial banks interest on their reserve balances, while superficially attractive, is very dangerous and likely to be counterproductive, for two kinds of reason.

That's a big suggestion, and the NIESR is often taken seriously, so it seems worth examining. This is their first argument:

First, it would imperil financial stability. Commercial banks' reserve balances are a large part of the stock of liquid assets that they are required to hold as part of the Basel 3 regulatory apparatus, to ensure that they can withstand a rush of deposit withdrawals without needing to be rescued. If no interest were paid on reserve balances, banks would want to get rid of a large proportion of them and, in order to avoid a surge of inflation, each bank would have to have a minimum quota of non-interest-bearing required reserves assigned to it. It would not be allowed to let its balance go below the quota, and the quota would ipso facto become an illiquid asset. The banking system would be less well protected against a liquidity crisis than it is now; if a crisis was threatened, the minimum quotas would have to be reduced or eliminated and government revenues would consequently fall.

All this does is reveal a complete misunderstanding of the issue being looked at. Central bank reserve accounts (CBRAs) do not exist because of Basel regulations. They do instead exist because the government chose to spend more into the economy than they chose to claim back as tax or gilt subscriptions. CBRAs are central bank created money injected into the economy by government choice. Commercial banks have no choice but to hold these balances. And collectively they cannot be rid of them: they can only transfer them to another bank, but their gross value will remain the same. They are, in that case, already a deeply restricted asset. The NIESR seems to know none of this. They should read my blog on this issue.

Their second claim is:

A further financial stability concern is that locking up bank assets in non-interest-bearing required reserves would aghttps://www.niesr.ac.uk/blog/dont-stop-paying-interest-banks-reserve-balancesgravate already evident shortages of liquidity in sterling financial markets. Financial markets have become accustomed to plentiful liquidity with strategic positions and assumptions based on that continuing. If the banks' assets become suddenly less liquid, they will be faced with an acute mismatch in the liquidity profile of assets and liabilities. Therefore, they will reduce the liquidity of their assets, which means extending less liquidity to the markets. As we have seen in gilt bid-ask spreads and in the pension fund LDI crisis, liquidity is already in short supply. The proposal would make this acutely worse, and thereby increase the risk of a full-blown financial crisis.

Again, this reveals a deep misunderstanding as to what these balances are.

Third, there is this:

Moreover, the imposition of minimum non-interest-bearing-balance requirements[2] on banks would be a tax on banks, the size of which would increase as interest rates went up. It would make banks less competitive in the market for financial intermediation, and financial flows would be diverted from the banking system into other less visible and less highly regulated channels, which lack depositor protection – shadow banking. This too would undermine financial stability.

This is absurd. The banks were gifted these assets since, as the Bank of England correctly says of itself when describing QE, it decided to create these reserve account balances, and yet it is claimed that to restrict the resulting unearned gain to the banks would be tantamount to an unfair tax. The logic is bizarre. First, why should the initial gift of liquidity be compounded by interest added, and second why should that be tax-free? The reasoning is not explained. Instead, having dealt with three issues we then get to their second point:

Second, implementing the proposal would involve what would amount to a default on the indemnity that the Treasury has provided to the Bank of England in connection with quantitative easing. The interest that would be withheld is currently paid by the Bank of England to the commercial banks, on reserve balances whose aggregate amount has been determined by the Bank of England, which has created the balances to pay for gilt-edged securities purchased in its quantitative easing programme. The gilts are held in the Asset Purchase Facility, a Bank of England subsidiary which is financed by a loan from the Bank of England proper. The Asset Purchase Facility is indemnified against losses by H M Treasury, which also gets the benefit of any profits (it has already received £120 billion).

There is more on this same theme, bewailing a breach of undertaking by the Treasury to the Bank of England and how calamitous this might be, all backed by a comment that the terms of the indemnity between the parties is unknown.

First, the terms of the indemnity are absolutely clear and have been known ever since QE began. The Treasury completely indemnifies the Bank of England for any losses it might make from undertaking QE operations. As a result it has also always taken the profit from them as well (albeit with a delay in early years). As a consequence, for accounting purposes, the Bank of England subsidiary that supposedly owns the bonds acquired by the QE programme (the Asset Purchase Facility, or APF) is not consolidated into the accounts of the Bank of England as law would usually require. There is good reason for that. It is clearly not a Bank of England-controlled company, even if legally owned by the Bank. Instead, it is obviously controlled by the Treasury. And we know that to be true: the Treasury has always had to provide prior written approval of QE operations. These letters are on public record. The only task delegated to the Bank is the micro-management of the programme. The real decisions are all taken at the Treasury.

As a result, the Treasury cannot be in breach of its indemnity to the Bank by not paying interest, because the reality is that QE is a Treasury operation, hidden behind a sham veneer of Bank independence, the lack of substance to which is revealed within the accounting treatment for the APF. To suggest that the Bank is in any way imperilled by a failure to pay interest on reserves, as the NIESR dies, is in that case absurd. That interest has never been Bank of England property and the accounting proves it.

The NIESR then extends this argument implying that non-payment would be breach of an implicit agreement with the commercial banks:

The commercial banks collectively have no control over the aggregate of reserve balances. The cost of the cessation of payments would be borne by bank shareholders, including pension funds, bank employees and bank customers. It would amount to a default and would pose a serious risk to the government's credit standing.

It is very odd that by this stage of the article the NIESR knows the restrictions on reserves that it apparently did not in the first part of it (were there two authors who did not understand each other, or read what the other wrote?). More tellingly, given that the Bank of England has commercial freedom to set whatever rates it likes this is simple nonsense. Nor can it in any way threaten government creditworthiness.

But then we get to this argument which is from cloud cuckoo land, so absurd is it:

None of this is to suggest that the practice of paying interest on commercial banks' reserve balances need continue forever. If the commercial banks were free to determine the size of their reserve balances, then it would be entirely reasonable for the Bank of England to say that it would not pay interest on them. That will be the case when, and only when, quantitative easing has been fully reversed. The banks' demand for reserve balances will probably be much larger then than it was before QE began, because many of the changes that have taken place in financial practices since then have required institutions such as clearing houses to hold accounts with central banks.

And it would be possible for the Bank of England to say now that it intends to cease paying interest on reserve balances when the reversal of QE is complete.

And that is it. On the basis of fantasies based on beliefs about situations that do not actually exist and probably never will in the last case, the NIESR wants to justify paying commercial banks a sum equivalent to 20% of the health budget over the next few years.

They did not use arguments I expected, like this being necessary if the Bank is to influence market interest rates. I presume they did not do so because they know that this is not true. We know that because interest on these reserves have only been paid since 2008, during which period rates were effectively zero until the last year, and so we have no way of knowing as yet whether this argument can be justified. It is however my suggestion that if signalling an interest rate costs this much then either the rate or the signal, or both, is wrong.

There was also no discussion on the links between monetary and fiscal policy.

Instead, there was just a misrepresentation of what the reserves are and a total misunderstanding of how they are managed.

I sincerely hope others trying to make this case do a lot better than this.