Funding the Future

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That there would be a meltdown in world banking was obvious to Danny Blanchflower and me as we worked on our submission to the Treasury Committee of the House of Commons, submitted last Friday.

As I have explained in an extract published this morning, if you push up interest rates so that the world's central banks could suck liquidity out of bank reserve accounts using quantitative tightening and simultaneously end the policy of quantitative easing only one outcome was ever going to be likely. We began writing some of this stuff late last year. The Committee then provided the hook on which to hang the publication. I admit the only thing we did not anticipate was the whole thing exploding this weekend or we would have got it out a week earlier.

Credit Suisse is the latest bank to fail. As they fall one after each other, to be bailed out in a fashion horribly reminiscent of the early autumn of 2008, the world should be waiting and watching to see what will happen next.

For the Swiss that is obvious: they are underwriting the losses in Credit Suisse on behalf of UBS. National pride and the currency are going to take a hit from that.

But if Credit Suisse could hide such obvious failings that immediate write-downs of its debt are required what other bank has similar issues hidden in its balance sheet? Again, there is a feeling horribly reminiscent of autumn 2008 this morning as the fear that no bank balance sheet can be relied upon is prevalent. And it does not matter much if those balance sheets are reliable: when KPMG signed off SVB's 2022 audit report without comment in February and PWC had already signed off Credit Suisse for 2022 without a going concern risk qualification, no one knows if any bank balance sheet can be relied on now. That is, once more, 2008 all over again.

No wonder the world's central banks have already opened a dollar credit line for the world's banks, just to keep them afloat.

But that is not enough. There needs to be a radical rethinking of central bank policy as another banking crisis emerges. This crisis was made by those central banks. Their policies and their failure to supervise created this outcome. As Danny and I said in the summary of our report:

We think QT and the associated policy of reducing or eliminating the APF is unnecessary because there is no evidence that UK or other financial markets have the capacity to absorb the sale of more than £800 billion of UK government gilts either now or in the future without:

* *Significantly increasing in UK interest rates with all the harmful consequences already noted in this submission.*

* *Severely limiting the ability to sell new government bonds, which would result in the imposition of a period of prolonged UK government austerity, and which might also significantly reduce the capacity of the UK government to invest, damaging the infrastructure of the economy on which the private sector depends and also leaving the country at risk of breaching its net-zero obligations.*

* *Severely reducing the funds available within central bank reserve accounts held by the UK's commercial banks with the Bank of England upon which balances the smooth operation of the UK banking system is now almost wholly dependent.*

* *Creating a recessionary economic environment which might, because of prolonged austerity, high interest rates and potentially high inflation have the risk of becoming a depression.*

* *Creating substantial social stress and potential disorder within the UK.*

This means that there is no identifiable reason for wishing to operate a policy of QT or to increase interest rates, which is the only identifiable reason for it, unless that is it is the desire of the government, Bank or England or both to:

* *Reduce growth in the UK economy.*

* *Increase unemployment.*

* *Increase financial risk.*

* *Precipitate an economic crisis.*

As a consequence of these observations and those in the submission that follows we recommend that:

* *The APF be maintained at its current value, or be* **increased**.

* That the current policy of the Bank of England to increase interest rates be reversed. Their current forecast is consistent both with cutting interest rates and/or reversing QT.

* That the policy of QT be abandoned.

* That a new QE programme of at least £50 billion a year for the next four years replace that QT policy.

We make these recommendations because unless they are adopted we fear that financial markets will be unable to finance the purchase of all the UK government bonds offered to them in the next few years without considerable increases in UK interest rates that will be profoundly harmful to the UK economy and the wellbeing of people in the country. The fragility of global financial markets in March 2023 is instructive.

As a result, in the interests of financial stability, economic growth, low inflation and stable government finances we believe that QT should be abandoned now.

Will the central banks change their policy now? We will know when the Bank of England reports this week. If rates go up, as many still think likely, then a cliff-edge policy is what they're going for. If they go for that I can say one thing with certainty and that is that we will go over that cliff.

Central banks have a choice now. They can service society or they can serve bankers. They cannot do both. What are they going to do?