Funding the Future

Children and pensioners suffer whilst banks profit enor...

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Larry Elliott had an article in the Guardian yesterday that addressed themes familiar to readers of this blog. He said:

There is nothing stopping the government finding £1.3bn for a new supercomputer and AI research, just as it is perfectly feasible to abolish the two-child benefit limit and to raise the social care cap. It could even do so without changing the fiscal rules provided it is prepared to stop paying banks interest in full on the balances they hold at the Bank of England.

As he noted:

Here's what going on. Since 2006, the Bank of England has paid interest on the reserve balances of commercial banks as a way of setting interest rates for the whole economy. The idea is that the banks won't be inclined to lend to their customers at a lower rate of interest than they get from the Bank of England.

As he then notes:

Initially, this had little impact because the reserve balances of the commercial banks were small. But the balances ballooned as a result of two big waves of bond-buying by the Bank of England, firstly during the global financial crisis of 2008-09 and again in response to the Covid-19 pandemic in 2020.

For more than a decade, the potential costs of remunerating reserves were hidden by low interest rates. Official borrowing costs were reduced to 0.5% in early 2009 and stayed pretty much at that level for the next 12 years. For a £2.5tn economy, paying £4bn-5bn a year interest on the commercial banks reserves was chicken feed.

But then rates went through the roof. As Larry notes:

Threadneedle Street is now paying 5% interest on £700bn of bank reserves at cost to the exchequer of £35bn a year.

Larry then agrees with me on this issue, saying:

Interest rates could still be controlled by remunerating a fraction of the reserves of the commercial banks.

For example, if Reeves decided to pay interest on only one-third of the reserves it would save her just over £22bn a year and fill the "black hole" in the government's finances without the need for spending cuts or tax rises. She could also reduce the national debt by about £400bn at a stroke.

As I argue, other central banks – including the European Central Bank and the Bank of Japan – operate a system of tiered rates so it is perfectly feasible for the Bank of England to do the same.

But as he then notes, Labour is so frightened of the City of London that they will still pay. But as he concluded:

If the choice is between paying the banks 5% interest on their Bank of England current accounts or investing in the future it really should be no contest.

Somehow it is, though. Children and pensioners suffer. Banks profit, enormously. How often does this have to be pointed out?