Written evidence submitted by Positive Money

Positive Money is a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

We welcome the opportunity to respond to this inquiry, to supplement the submission we made in the first round of consultation.

Key points:

- The government's reliance on bank loans as a means of emergency support has saddled businesses with unsustainable debt. With businesses set to default on tens of billions of pounds worth of state-backed loans, we are walking into an implicit bailout of the banks.

- A state-sponsored investment bank, and a network of regional development banks, to direct lending towards sustainable projects would be a key step towards catalysing a green transition, and would boost job creation and the 'levelling up' agenda.

- The Bank of England and HM Treasury have shown promising signs of working together to minimise the burden increased debt could place on the economy. They should coordinate more closely to ensure that new money is going more directly where it's needed, rather than boosting financial markets and inflating asset prices.

- The Bank of England's consideration of negative interest rates shows that the current monetary toolbox is broken. Rather, we need the Bank to create new money for the government to spend directly when interest rates are at the lower bound. This can be done through direct monetary financing.

How large a problem is corporate indebtedness? How effectively did the financial sector give assistance to businesses?

The government's reliance on bank loans as a means of emergency support has saddled businesses with unsustainable debt, which many will struggle to repay. High levels of corporate indebtedness is very likely to impede the economic recovery. Even before the pandemic hit the UK's private sector debt as a share of GDP was high. According to the OECD, private sector debt amongst both UK households and non-financial companies was 190% in 2019.[1] This has made lenders unwilling to support SMEs with emergency loans and is why the government had to step in to fully guarantee loans through the Bounce Back Loan Scheme (BBLS), meaning the public will absorb any losses from defaults. Even so there is evidence that banks have been hesitant to lend through restricting access to SMEs or applying credit check conditions.[2] The Bank of England's latest Monetary Policy Report indicates that there are signs of credit conditions tightening, particularly for sectors hit hardest by the pandemic, as banks expect high levels of private debt to result in more insolvencies.[3] Indeed, experts have estimated that businesses could default on up to 60% of loans distributed through the BBLS.[4]

---

[1] OECD, 'Financial Indicators – Stocks: Private sector debt', OECD website. Available at: https://stats.oecd.org/index.aspx?queryid=34814#

[2] Claer Barrett et al, 'Small businesses face ruin as UK lenders block access to Covid loans', *Financial Times*, 5 October 2020. Available at: https://www.ft.com/content/612e15fc-9508-4c31-bb2c-f77ed264dac8

[3] Bank of England Monetary Policy Report November 2020

[4] Ben Chapman, 'Taxpayers on the hook for billions of pounds of Covid loans made to criminals, report finds', *Independent*,

Business loan schemes have been designed to protect the interests of banks, who have been allowed to charge interest on loans that are fully guaranteed by the taxpayer. The BBLS was modelled on a Swiss programme in which loans were underwritten by the government to encourage lending. However, there was an important difference: in Switzerland banks are forbidden from charging interest on state-backed loans up to 500,000 Swiss Francs (£420,000).[5] This condition was dropped for UK lenders, who can charge interest of 2.5% per annum on guaranteed loans up to £50,000. This is an unreasonable rate for 100% guaranteed loans that carry zero risk for the lender. Under the Coronavirus Business Interruption Loan Scheme (CBILS), interest rates remain as high as 8.9%.[6] By contrast, the UK's largest corporations are benefitting from extremely favourable rates of around 0.3-0.7% through the state-backed Covid Corporate Financing Facility (CCFF).[7]

As the National Audit Office (NAO) has reported, banks are expected to net more than £1bn from the government in the first year of interest payments.[8] At the same time, also reported by NAO, the government could be handing between £15bn and £26bn to the banks through its Bounce Back Loan Scheme due to fraud and businesses defaulting.[9] This means we could be walking into another implicit bailout of the banking sector, with the public paying billions of pounds to cover banks' losses.

To ease the debt burden that businesses are facing at a time when their revenues have taken a hit, the government should, at the very least, stipulate that emergency loans must be interest free. The government should also seriously consider grants to stimulate small business, rather than burdening them with endless debt.

Is there a need for a new state sponsored investment bank? If so, what should it do?

There is a need for the government to do more to mobilise both private and public finances to support a recovery, and build a more resilient and sustainable post-pandemic economy. As 125 leading economists recently argued in an open letter to the Chancellor[10], the Treasury could allow the Bank of England to initiate a Green Investment Bank. For example, it could reinvest the maturing proceeds of the Covid Corporate Financing Facility (CCFF) into such a bank, which would not increase the government's net debt burden. A state-sponsored investment bank to specifically direct lending to sustainable projects could also have positive effects on job creation and support the government's 'levelling up' agenda. Moving forward, this will be particularly important as the economy will suffer from long-term scarring from higher unemployment and many businesses closing down.

7 October 2020. Available at: https://www.independent.co.uk/news/business/bounce-back-loans-national-audit-office-taxpayer-costs-fraud-criminals-b839472.html

[5] Swiss government, 'Coronavirus: Federal Council adopts emergency ordinance on granting of credits with joint and several federal guarantees', Swiss government website, 25 March 2020. Available at: https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-78572.html

[6] Adam Wiliams, 'Small businesses 'spend twice as much' by using wrong government loan scheme', *Telegraph*, 9 June 2020. Available at: https://www.telegraph.co.uk/money/consumer-affairs/small-businesses-spend-twice-much-much-using-wrong-government/

[7] Positive Money, 'The Covid Corporate Financing Facility: Where are the Conditions for the Billion £ Bailouts?', July 2020, p14. Available at: https://positivemoney.org/publications/ccff/

[8] Ben Chapman, 'Taxpayers on the hook for billions of pounds of Covid loans made to criminals, report finds', *Independent*, 7 October 2020. Available at: https://www.independent.co.uk/news/business/bounce-back-loans-national-audit-office-taxpayer-costs-fraud-criminals-b839472.html

[9] National Audit Office, 'Investigation into the Bounce Back Loan Scheme', Press Release 7 October 2020. Available at: https://www.nao.org.uk/press-release/investigation-into-the-bounce-back-loan-scheme/

[10] Positive Money et al. (November 2020). 'Open letter from 125 experts to the Chancellor on ambition for the future of financial services'. Available at: https://positivemoney.org/wp-content/uploads/2020/11/PUB-Letter-to-Chancellor-on-green-finance.pdf

This would by no means be unprecedented: similar actions were taken by President Roosevelt to support the New Deal in the 1930s and by the Bank of England itself, who supported the creation of the Industrial and Commercial Finance Corporation and Finance Corporate for Industry after the Second World War.[11] [12]

The government's decision not to sell off of its 62% stake in Natwest (formerly the Royal Bank of Scotland) presents a key opportunity in this area. The government could buy the remainder of RBS and bring it under full public ownership. It could be used as a vehicle to create a network of regional development banks, to support productive investment in small and medium enterprises (SMEs), green industries and manufacturing. This would rebalance patterns of lending by UK banks towards more productive investment in the 'real' economy rather than towards unproductive financial assets and property.[13]

How effectively did the Government work with the Bank of England? Was fiscal and monetary policy well-coordinated? Do there need to be changes to the monetary and fiscal framework?

(i) Fiscal-monetary coordination

The government and the Bank of England must work together to take advantage of the conditions for monetary financing to minimise the costs of higher public spending. In response to the Covid-19 crisis, the Treasury and the Bank of England have engaged in monetary financing. 'Monetary financing' refers to various arrangements whereby the central bank's power to create new money is used to support government spending. The Central Bank exchanges newly created money for government debt and holds this debt permanently on its balance sheet. To date, this has involved Quantitative Easing (QE), an 'indirect' form of monetary financing, where the Bank of England purchases government bonds in the market from non-bank financial institutions.[14] Since March 2020, the Bank of England has conducted three rounds of QE amounting to £450bn. This takes the cumulative total of bond purchases up to £845bn between 2009 and 2020.[15]

There have been welcome signs of increased fiscal-monetary coordination over the course of the pandemic. £200bn of QE was announced the day before the Treasury announced plans to pay 80% of private sector wages, indicating that it was coordinated to help keep borrowing conditions easy for such a huge fiscal expansion. The chief executive of the Debt Management Office has suggested the government would have struggled to pay for its lockdown rescue package without the BoE's expansion of QE.[16]

Moving forward there is scope for more effective and explicit fiscal and monetary coordination. The Treasury and the Bank of England should ensure that newly created money is directly invested where it is needed, rather than going indirectly through financial markets, which inflates asset prices and typically relies on an inadequate 'trickle down' effect.

(ii) Direct monetary financing

[11] Ryan-Collins, J., & Van Lerven, F. (2018). Bringing the helicopter to ground: a historical review of fiscal-monetary coordination to support economic growth in the 20th century. UCL Institute for Innovation and Public Purpose Working Paper Series (IIPP WP 2018-08).
[12] Capie, F. (2010). The Bank of England: 1950s to 1979. Cambridge University Press.
[13] Konstantin Bikas. (June 2018). 'How has bank lending fared since the crisis?', Positive Money Website. Available at: https://positivemoney.org/2018/06/how-has-bank-lending-fared-since-the-crisis/
[14] David Barmes. (April 2020). 'The Ultimate Magic Money Tree Has Been Unveiled – Don't Let the Government Tell You Otherwise', Positive Money website. Available at: https://positivemoney.org/2020/04/the-ultimate-magic-money-tree-has-been-unveiled-dont-let-the-government-tell-you-otherwise/
[15] Bank of England. (2020). 'What is quantitative easing?'. Available at: https://www.bankofengland.co.uk/monetary-policy/quantitative-easing
[16] Philip Aldrick, 'Investigation into the Bounce Back Loan Scheme', *The Times,* 30 April 2020. Available at: https://www.thetimes.co.uk/article/bank-of-england-rode-to-government-s-rescue-as-gilt-markets-froze-w8dkqvvkg

The pandemic and the challenges it will pose for the economy highlight the need for greater monetary and fiscal policy coordination to enable the Bank to support the Treasury to maximise its fiscal capacity. The fact that the Bank of England is considering introducing negative interest rates shows that the current toolbox is no longer fit for purpose. Rather than taking rates below zero (which could have unintended side effects), the Bank should create new money for the government to spend directly when interest rates are at the lower bound.

The government could make better use of the central bank's money creation tools through what is commonly referred to as 'overt' or 'direct' monetary financing.

There are two obvious ways that the government could start doing this:

1. By going through the **primary market**, the Bank would use QE to buy gilts directly from the Treasury's Debt Management Office, which would mean newly created money going straight to the government's account, as opposed to via financial intermediaries on the secondary market.
2. The **Ways and Means** is the government's 'overdraft' with the Bank, in which the Bank credits the government's account directly with newly created money. The Bank's extension of this facility to an unlimited amount in April 2020, in response to the Covid-19 crisis, offers an even more direct means of monetary financing.[17] The Bank could also initiate this by crediting the facility with funds for the Treasury to spend instead of resorting to negative interest rates. As yet the government has not taken advantage of this, with the size of its outstanding balance remaining flat at £370m since 2009.[18]

The Ways and Means facility could form the basis of a 'standing emergency fiscal facility', as proposed by BlackRock at Jackson Hole in 2019, as a means of responding to the next recession when interest rates are at the lower bound.[19] Instead of taking the base rate below zero, the Bank of England could credit the Ways & Means facility with non-repayable funds for the Treasury to spend. This would mean the Bank of England retains control over the scale of direct monetary financing in order to manage inflation.

Direct Monetary financing also allows the government to avoid the negative side effects of QE. For example, by pumping large amounts of money through financial intermediaries QE has fuelled asset price inflation and inequality.[20] The richest 10% of households are estimated to have benefited by £350,000 each from asset price inflation through the first £445bn of QE after the financial crisis.[21] Given further rounds of QE are likely to increase wealth inequality it may be necessary to consider more active fiscal policy, such as wealth taxes to offset the growing inequality caused by asset price inflation. Additionally, QE has largely failed to achieve its stated objectives to encourage lending in the real economy.[22]

Concerns that monetary financing would be inflationary are inconsistent with empirical evidence. Despite the Bank of England's QE programme following the 2008 financial crisis, inflation has remained low. Given the current expectations of high unemployment and low aggregate demand, deflationary pressures pose a greater

[17] Bank of England, 'HM Treasury and Bank of England announce temporary extension to Ways and Means facility', Bank website, 9 April 2020. Available at: https://www.bankofengland.co.uk/news/2020/april/hmt-and-boe-announce-temporary-extension-to-ways-and-means-facility

[18] RPWB72A | Bank of England | Database

[19] Blackrock, 'Dealing with the next downturn', Blackrock website, 15 April 2019. Available at: https://www.blackrock.com/corporate/insights/blackrock-investment-institute/publications/global-macro-outlook/august-2019

[20] Positive Money, 'How Quantitative Easing Works', Positive Money website. Available at: 'https://positivemoney.org/how-money-works/advanced/how-quantitative-easing-works/

[21] Bank of England. (March 2018). 'The distributional impact of monetary policy easing in the UK between 2008 and 2014'. Available at: https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/the-distributional-impact-of-monetary-policy-easing-in-the-uk-between-2008-and-2014.pdf

[22] Giansante S., Mahmoud Fatouh M. and Steven Ongena S. (2020). Bank of England Staff Working Paper No. 883. "Does quantitative easing boost bank lending to the real economy or cause other bank asset reallocation? The case of the UK." Available at: https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2020/does-quantitative-easing-boost-bank-lending.pdf?la=en&hash=2073590C2F81603255AC93A57F6B8885BCD8748D

risk for the economy.[23] Indeed, the BoE's own projections indicate that inflation will not return to it's 2% target for another 2 years.[24]

Like any form of spending, monetary financing may be inflationary if it does not generate productive output or reduce debt burdens. However, in the context of significant spare capacity in the economy, monetary financing can be directed to areas that will stimulate the real economy and the production of new goods and services. Through generating employment and boosting incomes, this will also facilitate the reduction of debt burdens. As such, a more coordinated approach between the Treasury and the BoE is needed to ensure newly created money is directed to where it is most needed to support the recovery.

(iii) Transparency

An additional area of concern regarding the government's recent approach to monetary-fiscal coordination has been the notable lack of transparency from the Treasury and the Bank around decision making. For example, the design of the Treasury's and Bank of England's joint scheme, the Corporate Financing Facility (CCFF) lacks transparency which prevents public scrutiny over the use of public money. Despite agreeing to publish the names of individual companies participating in the CCFF there is no publicly available record of the total amounts borrowed by each company for the duration of the scheme or how loan amounts are determined. As Positive Money highlighted in a July report "this perpetuates an ongoing trend since the financial crisis of 2008 of the Treasury granting ever-greater powers to the Bank of England, without developing sufficient accountability mechanisms that ensure democratic legitimacy".[25]

We would welcome greater transparency on the coordinated efforts of the Treasury and the Bank, for instance by supplementing the Inflation Report and Financial Stability Report inquiries (conducted by the Treasury Select Committee) with evidence from a board of independent academics and civil society representatives.[26]

December 2020

---

[23] Barnes D. (2020). Positive Money. Why COVID-19 should make us rethink the concept of inflation. https://positivemoney.org/2020/05/why-covid-19-should-make-us-rethink-the-concept-of-inflation/

[24] Bank of England (Nov 2020). Monetary Policy Report. Available at: https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2020/november/monetary-policy-report-nov-2020.pdf

[25] Positive Money. (July 2020). 'The Covid Corporate Financing Facility: Where are the Conditions for the Billion £ Bailouts?'. P14. Available at: https://positivemoney.org/publications/ccff/

[26] Positive Money. (October 2019). 'Seeking Legitimacy: A new settlement for the Bank of England'. P6. Available at: http://positivemoney.org/wp-content/uploads/2019/10/Positive-Money-Seeking-Legitimacy.pdf