Banks have got ahead of the curve when it comes to cheap money

Philip Aldrick
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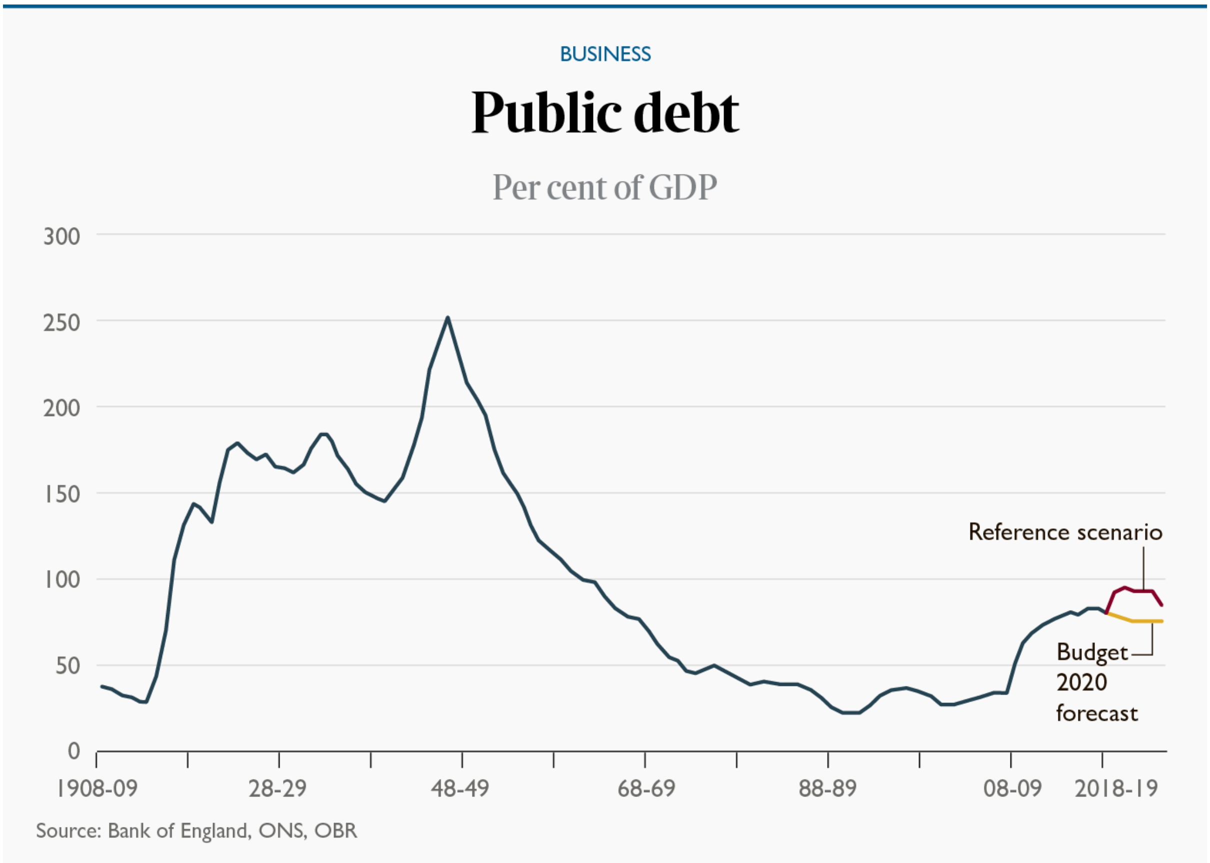
In 1945, with Labour in power after the Second World War, Hugh Dalton became the "cheap money" chancellor. Cheap money had been a mainstay of UK economic strategy since 1932, when the Treasury converted a 1917 war loan into a low interest bond. But Dalton wanted to take the policy further than ever to support peacetime reconstruction.

Shortly after moving into No 11, Dalton cut the main borrowing rate from 1 per cent to 0.5 per cent and the following year infuriated the City by converting a 3 per cent bond into 2.5 per cent Treasury stock to lower government borrowing costs right across the yield curve.



What made his plans possible was the nationalisation of the Bank of England in March, 1946. The Bank turned Dalton's plans into reality through "large scale intervention in the market", as David Kynaston writes in *City of London, The History*.

Wartime analogies have been two a dozen since the coronavirus outbreak, one of which has been the damage to the public finances. Public debt soared during the war and is soaring again. Cheap money was Dalton's version of what is now known as "financial repression", letting prices rise faster than interest rates to shrink the debt stock, effectively a tax on financial assets. With the Bank under state control, “the fate of gilt-edged investors now turns on the whim of the chancellor”, *The Economist* magazine wrote at the time.

On Thursday, the Bank will set out its monetary and financial policy alongside its first forecasts since the lockdown, with the main question on many economists’ minds being whether this is the start of another period of financial repression.

For many the answer is, yes. The new vocabulary is “yield curve control”, the act of holding down both short and long term rates as Dalton did in 1946. At 0.1 per cent, the Bank has cut short rates to a historic low and is using £200 billion of quantitative easing to manipulate long rates. Every pound raised in markets by the government for the Covid-19 bailout is matched by a pound bought by the Bank. It is not buying directly but it is using demand management to lower borrowing costs.

At the current run rate, however, quantitative easing expires at the end of next month. The question is whether Andrew Bailey, the new governor of the Bank, will agree to open-ended quantitative easing just as the US Federal Reserve, European Central Bank and Bank of Japan have to keep borrowing costs down?

Rupert Harrison, George Osborne’s former economic adviser who is now a portfolio manager at Blackrock, is in no doubt. “Central banks have crossed a rubicon. They are explicitly or implicitly practising yield curve control . . . We have full fiscal dominance . . . I think there will be financial repression,” he said at a Tony Blair Institute webinar last week.

Yield curve control is a trap from which it will be very difficult to escape. The bigger the national debt, the more urgent it is to keep borrowing costs low. Debt exploded during the Second World War but it was afterwards, when the government sought to rebuild, that Dalton ramped up cheap money. George Buckley of Nomura says that the crisis “has put paid to any talk about rate hikes for many years”.

There will be consequences for “full fiscal dominance”, where the Bank operates “at the whim of the chancellor”, as *The Economist* might have put it. This time, the chancellor does not have to nationalise the Bank, though. Its 2 per cent inflation mandate can be changed. But never again will the Bank be able to argue against the magic money tree advocates who want it to print money for the green energy transition.

To save the economy in this war against the virus, the Bank risks sacrificing its independence.

Philip Aldrick is Economics Editor of The Times