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Mark Carney warns EU faces financial drought if it cuts off UK overnight - but cautions Trump, China and debt could knock us off course

By Tim Wallace

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The European Union desperately needs finance from Britain and will face severe knocks to its economy if member nations do not agree to a transitional period to give banks and finance firms time to adapt to Brexit, Mark Carney has warned.

The Governor of the Bank of England wants a smooth changeover when Britain leaves the EU, to give companies time to adapt to the new setup, and avoid any wrenching change in the economy or in the financial markets.

That means Britain would not necessarily switch overnight from one regime to another when leaving the EU, which is expected to take place in early 2019.

“Banks located in the UK supply over half of debt and equity issuance by continental firms, and account for over three-quarters of foreign exchange and derivatives activity in the EU,” Mr Carney said.

“If these UK-based firms have to adjust their activities in a short time frame, there could be a greater risk of disruption to services provided to the European real economy, some of which could spill back to the UK economy through trade and financial linkages.”

That potential disruption comes from Britain’s status as the EU’s major global financial hub.

“The UK is effectively the investment banker for Europe,” Mr Carney said, noting that funds are raised by British-based banks from British-based investors, to fund economic activity.

“These activities are crucial for firms in the European real economy, and it is absolutely in the interests of the EU that there is an orderly transition and there is continual access to those services.”

The Governor has been criticsed for his interventions on Brexit in the past, facing accusations that he wanted the UK to remain in the EU and tried to sway the debate.

Presenting the Bank of England’s financial stability report, he sought this time to align himself with Theresa May.

“As the Prime Minister has said, it is preferable that the process is as smooth and orderly as possible,” he said.

“It is preferable that firms know as much as possible about the desired end point [of the Brexit negotiations] and as much as possible as soon as possible about the potential path to that end point.”

That should mean businesses on both sides of the Channel are able to prepare for Brexit when it takes place, minimising any disruption.

Jacob Rees-Mogg has been one of Mark Carney's fiercest critics, taking aim at the Governor's comments around Brecit CREDIT: RICHARD GARDNER/REX/SHUTTERSTOCK

“[Finance] firms are making contingency plans for a variety of potential outcomes, as we’d expect them to do. As supervisor, we have direct line of sight to those contingencies, and we know exactly what they currently intend to do under any circumstance,” said Mr Carney.

He believes that the average bank would need less than two years to implement its contingency plans for Brexit, once it knows exactly what it is preparing for.

That sets the scene for a much shorter transition period than the five to 10 years sometimes proposed by finance bosses and lobbyists.

China is the biggest risk to financial stability

Other risks to financial stability identified by the Bank of England include the buildup of debt in China, the potential for Donald Trump’s spending plans to cause the US economy to overheat, political risks in the eurozone, and the increase in household debt in the UK.

“The most significant risks to UK financial stability are global,” said Mr Carney.

“China’s non-financial sector debt has risen…. to 260pc of GDP. This is extraordinary leverage for an advanced, let alone emerging, economy.”

That is an increase from 160pc of GDP at the time of the financial crisis, and the Bank of England fears it leaves China “vulnerable to external shocks”.

Donald Trump could destabilise markets

One such shock could be a sharp rise in US interest rates, potentially prompted by President-elect Donald Trump’s plans to slash taxes and hike government spending.

“A significant fiscal stimulus at a time when the US economy is increasingly operating at close to full capacity … the consequence of that has been an increase in US market rates, the first elements of so-called snap-back risk, and a strengthening of the US dollar,” said Mr Carney.

The US economy is growing relatively well, but Donald Trump still plans a $1 trillion spending spree, which is expected to push up interest rates CREDIT: EVAN VUCCI/AP

Snap-back risk is a central banking term for a sharp jump in interest rates, rather than the slow and steady change which officials hope will take place in the coming years.

Higher rates would be expected to push up the dollar and encourage flows of capital from emerging markets and into the US, potentially hitting growth in those markets and creating financial instability.

Britons at risk from debt binge

In the UK the Bank of England noted that households are starting to increase borrowing, for the first time since the financial crisis.

Households’ debt as a proportion of their incomes has fallen by around 20 percentage points since the credit crunch.

That is now increasing, in part because higher house prices mean homeowners need bigger mortgages, but also because credit card debt is on the up.

“The good thing is households and businesses, young families looking to buy a home, can get access to credit, and get it on quite competitive terms,” said Mr Carney, arguing that the low interest rates which encourage this “are necessary for the economy, given the headwinds the economy is facing.”

But he said the Bank of England also has to make sure those loans are being given out responsibly: “We have tools that can help ensure the underwriting standards are responsible, that [the loans] are going to people who are likely to be able to pay off those debts. It doesn't do anybody a favour - the individual, the bank or the economy as a whole - if we slip into a position where that discipline is lost.”

The Bank of England’s report looked at how the fall in commercial property prices in 2016 had posed a threat to banks’ financial stability because of the market’s reliance on inflows of foreign capital.

It highlighted concerns about assets held in open-ended funds, many of which closed in the aftermath of the referendum over concerns about high levels of redemptions.

“While suspensions helped to avoid widespread, rapid sales of commercial real estate following the referendum, the underlying vulnerability that could arise from the liquidity mismatch between these funds’ assets and liabilities remains,” the report said.

It added that any future shocks to the commercial real estate market could trigger “similar cycles of redemptions, suspensions and discounted sales”, and said that it supported the FCA’s intention to publish a paper around the challenged of holding illiquid assets in open-ended vehicles.