Funding the Future

nly modern monetary theory can save the economy from T

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I posted this thread on Twitter this morning:

Over the next year the government is going to run a deficit. If we look at the 12 month period the forecast is for about £75bn, based on March 2022 estimates. But this is now going to get very much worse. A thread….

We now know inflation is worse than expected. We know the deficit was bigger than expected in August. We know that even after price caps inflation is expected to exceed 11%. And we know recession is very likely. The deficit is likely to increase as a result.

But we also now know there will be £30bn of tax cuts. There is no evidence that this will lead to growth.

We also know energy support for households might cost £100 billion. I suspect the uncosted business package might add £50 billion to that sum.

In addition, with the Bank of England intent on increasing interest rates I suspect government borrowing costs will increase by well over £20 billion in the next year.

Add just that data together and the deficit in the next year might easily exceed £275bn. That is wholly unprecedented in UK economic history.

And now the Bank of England has announced that it will also be selling £80 billion of the government debt that it technically owns back into financial markets over the next year.

Add this factor into the mix and what it means is that the Treasury plus the Bank of England will be seeking total funding of £355 billion (or more) from financial markets over the next year or so.

There is no precedent for the government and its agencies wanting funding of this sort from financial markets in such a period. In the years of maximum deficits (2009, 2020, 2021) the deficits were very largely or entirely covered by quantitative easing.

When QE is used the BoE creates new money for use in the economy; the Treasury sells bonds to the financial markets to apparently reclaim that money from markets; and the BoE then purchases bonds of equivalent value, effectively cancelling those bonds and the demand on markets.

As a result, nothing like the sums to now be demanded from the financial markets has ever been sought before. So, the question is whether it is plausible to seek £355 billion or so?

The answer is that it utterly implausible without some massive conditions being attached. One of those will be considerable interest rate increases, which will be disastrous for the rest of the economy, as I have explained on other threads.

The other condition to note is that funding for investment in other activities by financial markets is bound to be reduced if £355 billion is sought by the government and its agencies, again increasing the risk of recession.

These conditions are too big for the economy to bear. The recessionary impact of them is far too big. So the question that has to be asked is how this sum might be funded instead?

QE could be used for this purpose, but only results in an increase in the balances held by commercial banks on deposit with the Bank of England on which base rate interest is paid, which is a significantly increasing cost. That makes that approach inappropriate now.

In that case the current level of funding requirement requires three things. One is the cancellation of BoE plans to sell bonds they own: this is obviously a wholly inappropriate plan now.

Second, QE should not be used utilising existing arrangements where commercial banks see their base interest rate bearing deposits with the Bank of England increase gratuitously as a result.

Third, instead the new money that the Bank of England must necessarily create to fund the planned level of government spending (because all state spending is initially funded in this way) should be advanced interest free to the Treasury.

Then, fourthly, when those funds are spent into the economy they should be credited to what might be called special reserve accounts to be held by the commercial banks with the Bank of England on which interest of no more than 0.1% should be paid.

I am aware that this sounds like a technical issue, but it matters. These special reserve accounts need never be repaid. The interest rate would make them affordable into the future without limit, or concern.

But it's also the case that technicalities are going to matter greatly on this issue. I doubt the capacity of the financial markets to provide anything like the £350bn it is assumed by the government that they can fund in the next year.

Without alternative and technically plausible answers to this funding issue it is very obvious that within the next year we are going to face a financial meltdown. So far this issue is not being discussed.

The absence of an OBR report to accompany the statement from the Chancellor this week only exacerbates the surreal lack of macroeconomic debate about the crisis we are facing.

My sense is that the government is at present doing fantasy economics. The reality is that their plans are going to crash down remarkably soon.

We should be very worried precisely because the government is pretending it isn't and the Bank of England is determined to make things worse. If we do not get a sense of reality from either soon my sense of foreboding can only grow.

And one final point: what I am suggesting is as close to a modern monetary theory solution as I can get within the constraints of current central bank arrangements in the UK. And I am suggesting it because only MMT can address this crisis.