Funding the Future

Why the OBR's view of the economy is so wrong

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I posted this thread on Twitter this morning. It is a discussion of the Office for Budget Responsibility's latest long-term report and forecast issued this week, with which (you will find) I am not terribly enamoured:

The Office for Budget Responsibility (OBR) issued a report this week saying that the UK's national debt is out of control. It forecasts it will grow to maybe 300% of GDP by 2070. But there were massive errors in the report and a lot of handwringing and no solutions. So, a thread....

If the OBR is to be believed, the UK is heading for economic hell. It isn't. It may be heading for climate hell, but assuming we address that issue, economic hell is not on the agenda.

This thread is in three parts. The first is what the OBR got wrong. The second is about what they could have said about the state we're in. And the third is what they should be saying about the future. All of them suggest that the report was seriously deficient.

The OBR started with some totally false assumptions. Their report was doomed from the moment that they made them. So let me explain what they were.

First, they said that the national debt is now a little over £2,500 billion. As a matter of fact, it is not. That's just what the Office for National Statistics (ONS) says it is, but they have got the accounting all wrong.

There are two massive adjustments required to that number. One is to take out what is called the Bank of England (BoE) contribution to the national debt. The ONS say that this is about £300bn. It isn't. There is no such number on the BoE balance sheet.

In fact, this number only exists because the ONS refuse to recognise that the BoE has assets to match the liabilities that the ONS include in the national debt. Because the

ONS refuses to recognise those assets it claims there is a debt when in real terms there is none.

That takes about £300bn off the national debt. The second figure to take off is bigger. That is the money held on deposit by the UK's commercial banks with the BoE. This figure is a bit over £800bn at present, having been £900bn a year or so ago.

The money in question was almost entirely created during the 2008 and 2020 crises. It was used to keep the commercial banks afloat in 2008/9/10 and the country afloat in 2020/21.

The money in question was new money, created as all government money is by the Bank of England on behalf of the government and spent by the government into the economy to support public services, which is its job.

In effect, the new money was nothing more than an advance from the BoE to the Treasury, but because such ab advance was not allowed under EU rules, the quantitative easing (QE) process had to be used to disguise that it had been made.

QE is confusing, but also - as in this case - a complete sham. It was used to make it seem that there is no magic money tree, which there is, and which is otherwise called the BoE.

QE requires that bonds be issued by HM Treasury (HMT) that are sold to banks and other buyers to then be bought back by the BoE, sometimes within a week or so. The only purpose for doing this was to disguise the BoE actually lending HMT money, which is what really happened.

HMT spent that money created for it by the BoE into the economy. The only way to do that was to pay it to the commercial banks, who then paid it on to their customers on behalf of the government as furlough payments and whatever else the government wanted to pay.

Few people have a problem understanding that. But most people, including the OBR and the ONS have a problem with the resulting accounting.

The ONS ignores the loan from the BoE to HMT that then resulted in payments being made to the commercial banks that in turn left those commercial banks with apparent deposit account balances owed to them by the government.

Pretending things have not happened is never good accounting. But the ONS makes it worse by then pretending that the bonds that the BoE bought back that were previously issued by HMT are still in existence - when very obviously the government cannot owe itself this debt.

So, the ONS has £800bn of government debt in its figures that is owed by the government to itself.

The ONS gets all its accounting wrong then - its figure for the national debt is overstated by at least £1,100 billion as a result. As accounting errors go that's on the mega scale, and almost because it is it seems no one is really willing to challenge it, except me.

That said, the OBR do realise that the true debt owing is not the bonds issued by HMT and now owned by the BoE (as the ONS claim) but is instead the new money created by the BoE for the government that is now sitting in the deposit accounts of the commercial banks held with the BoE.

I know this because their debt calculations make that clear. But then the OBR fail to recognise the very special nature of this supposed debt. It is in fact not debt at all, because those banks cannot ever demand it be repaid. Nor can they ever use it to pay anyone but another commercial bank.

It is, in fact, not debt at all because it is what is called 'base money'. The BoE describe it as such. And base money is simply the government-created money that is used within the closed network of accounts created by the BoE to ensure that banks can always pay each other.

The weird thing about base money is that the banks cannot freely use it. What is more, it cannot be repaid. And the BoE can't cancel it either except (and this is a big 'except') by doing quantitative tightening (QT).

QT is the weird process where the BoE pretends that the sham transactions that made up QE can be reversed by selling the bonds that it technically owns back into financial markets. Right now, the BoE is doing QT, and for just one reason.

The BoE is selling these bonds, that were in effect cancelled, back into financial markets solely to push up interest rates. This makes the government's debt figures very much worse whilst also pushing up the cost of servicing that debt.

But I stress, although this reduces the amount of base money in existence it still does not make base money debt. The existence of base money and the existence of bonds that the BoE claims it should sell are at most remotely related to each other.

So, back to the OBR and the mistakes they have made. First, they claim base money is debt - and in a very real sense it is not. As such it should not be included in the calculation of the national debt. It should be separately categorised for what it is.

Second, they ignore the fact that the BoE is alone amongst central banks in actively pursuing QT sales of bonds right now. Instead they seem to accept this as a fact that does not require comment, and then ignore the massive impact it is having in forcing up UK interest rates.

So, the question has to be asked in that case whether the OBR really understands the nature of the national debt, or of base money, or the exceptional actions of the BoE in pursuing active QT when no other central bank is.

If the OBR did understand these things they could use them to explain the exceptional and unusual performance of the UK when it comes to debt and interest rates - which are both aberrant because the actions of the BoE which are intended to make things worse, but the OBR don't.

For these reasons, the OBR report gets off to an appalling start. The OBR also, incidentally, also fails to notice something else. That is that the ONS massively overstates the UK's GDP, which is significant in this context.

The ONS includes a figure which is usually about 10% of GDP (or about £250bn a year right now) which they say represents the value of the rent UK owner-occupiers pay themselves for the right to live in their own homes. This figure is, of course, pure nonsense.

It is included in UK national accounts to supposedly make them comparable with countries like Germany where renting is much more prevalent, but it nonetheless means that the figure we use for national income for the UK is utterly meaningless: it is made up.

Adjusting for these errors (£300 for the BoE contribution to debt; £800bn for base money and £250bn off GDP) the national debt reduces from £2,550bn to about £1,450bn and GDP to £2,300bn, which leaves a debt to GDP ratio of 63%. So, what are we worrying about?

Now let me address the second issue, which is what the OBR should have been saying about what they call the exceptional position the UK is now in.

They say our position is exceptional because our debt has risen in cost more than other countries and that debt's supposed life before repayment date has fallen considerably. In addition, we have exceptional amounts of indexed linked debt. They are panicking about all three.

What they have not said on the cost of debt is that the reason why our government's debt is so expensive is because the BoE has forced interest rates up to exceptional levels here, not least by making QT sales of government bonds for the sole purpose of achieving that goal.

In other words, the OBR fails to note that our debt is so expensive precisely because the BoE has, as a matter of policy, decided to make it inordinately expensive. That appears to be a massive oversight on the OBR's part.

As a result, the OBR also fails to mention the ways in which this can be corrected. They do not say that the BoE could cut its base interest rate, not least because it being so high appears to have had no effect on inflation except, perhaps, to increase it (as I have argued).

And they fail to mention that the QT programme that the BoE is pursuing to purchase rates up could also be cancelled, even though that is very obviously possible.

In addition, they fail to mention that the payment of bank base rate by the BoE on the deposit accounts maintained by the UK's commercial banks with it is not a legal necessity and nor is it the international norm. Overall, Japan and the European Central Bank pay much less.

They also fail to mention that whilst we have excessive index-linked bonds in issue right now many of those bonds are trading on financial markets at well below their theoretical value. That's because markets are not pricing them to the time of their redemption, but the ONS does.

It would, in fact, look to be possible for the UK government to buy many of the index-linked debts in issue right now and replace them with normal gilts and make a profit by doing so, reducing the national debt in the process. But that is also not mentioned.

Nor is the fact that the UK has a higher proportion of overseas owners of our government bonds than average, which the OBR sees as a threat, when in reality if those owners get stroppy we know that the government can always fund itself without borrowing by creating more base money.

In other words, the OBR pretends that the current state of play in financial markets is a given when that is anything but true, which is deeply disappointing to note.

So what should the OBR be saying about the future of the UK's debt? I suggest a number of things.

The first would be that we should get the accounting for debt right before starting to project figures for it until 2070. In other words, they should be asking the ONS to provide reliable debt data as the basis for projection instead of the nonsense that the ONS currently create.

Then the OBR should make some realistic assumptions - such as the fact that the real cost of UK government debt is going to fall considerably soon because it is currently massively artificially inflated and that is unsustainable.

After that they could also say that if foreign owned of UK government debt want to get uppity about any issue that's no problem: QE has been proven as a technique and the one thing that it is good for is stabilising debt markets, which it could be used to do again.

But perhaps most importantly, the OBR could end its obsession with the size of the national debt and the capacity of the state to service it. Like the ONS, the OBR reveals in its work the fact that it does not understand the double entry accounting that underpins the national debt.

The national debt only exists because people want to own it. Those people are banks, pension companies, life funds, foreign governments and private investors. In other words, the national debt is not just an issue for the government but also for all those who want to own it.

The reasons why people want to own national debt are threefold. First, the government is the only organisation that can never fail to return a saver's money because a government cannot default on debt because it can always create some new money to make the required repayment.

Precisely because people know that fact government debt is especially attractive to many savers with private wealth, but most especially those like banks, pension companies and life funds who have a duty to not lose money.

Second, people do not own national debt issues like government bonds because the rates of return are great. They know they are not. They own them for security. This makes the BoE's attempts to push up interest rates on government bonds most especially foolish.

Third, people buy government debt because it is a safe way to save in sterling - which is why there are so many foreign owners of that debt. The UK relies on foreign savings to make its books balances. We need government debt to provide a safe place for foreigners to save.

On top of all this, the OBR ignores the fact that as a population ages its savings get bigger because we get richer as we get older. The OBR has noticed that the UK has an ageing population but has appeared to entirely forget that this means that we will need more bonds.

Why will we need more bonds? Because it is government bonds that will underpin all the extra private pensions that we will be paying in future and unless the government makes those bonds available to savers by increasing the supply the pension market will be in deep trouble.

I could go on, but now I hope I have made it very clear that the OBR has produced a scaremongering report that starts from the wrong point, fails to analyse the current data, and does not reveal an understanding of the trend in future saving needs.

What else is there to say? Five things. First, if this is the best the OBR can do it needs urgent reform. What this piece of work reveals is that it is deeply unquestioning of the government when the whole purpose of its supposed independence was that it should question it.

Second, the ONS should be required to provide meaningful data for decision-making purposes that is actually based on the reality of what is going on in the UK economy and not on meaningless accounting fiction, which is what it is doing at present.

Third, the OBR, government, ONS and most of all the Bank of England need to understand the true nature of government debt, why it exists, what it is, how it is used, and that base money is something different to debt.

Until our national economic agencies cease to live in a wholly inappropriate paranoid state about debt - which has a wholly constructive role to play in our society both now and in the future - we are going to get really poor decision-making about it.

Fourth, it really is time that the Bank of England stopped trying to undermine the well-being of this country by wholly artificially forcing up interest rates.

Finally, and fifth, we need to understand that government debt is just the flip side of private wealth. If that rises because an ageing population has saved more then of course we should expect the national debt to rise. It's time to stop fretting about a good thing.

I apologise for the length of this thread. Thank you if you go through it. I apologise if I rushed some things. But this stuff is really important - and unless it is understood we are going to suffer really bad economic decision-making in this country that we really cannot afford.

ENDS.