Funding the Future

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My friend and Green New Deal colleague Larry Elliott had an article in the Guardian last week on what he described as the return of the bond vigilantes.

The article is, I suggest, worth reading, and when commenting here I am going to assume those continuing to read this post will have done so. That prevents me from having to repeat all his arguments.

That said, his main points are:

* Central bank interest rates should be at their peak now given that inflation is falling and economies are clearly heading for a recession.
* Despite that, they are still rising in international financial markets.
* International stress is insufficient to explain this phenomenon.

I would add that the classic indicator of a forthcoming recession - which is the existence of the so-called inverted yield curve, which in plain English means that interest rates on two-year government bonds are illogically higher than those on ten-year bonds - is still being widely seen. This has been a classic indicator of a forthcoming recession for a long time.

Larry's explanation for what is happening is fairly straightforward. It is his suggestion that the chaos is not caused by stress about government funding - although there has never been a time when neoliberal financial markets have not said that governments are overreaching their spending capacity. Instead, he puts the blame for the bizarre situation on quantitative tightening (QT).

As I explain in the glossary to this blog:

QT represents the reversal of the quantitative easing (QE) process. As a consequence, a central bank pursuing a policy of QT will sell back to the financial markets some or all of the bonds that it acquired when undertaking quantitative easing.

QT can be motivated by a desire to:

* *Force interest rates upwards. This is done by making more government bonds available to financial markets. That increased availability reduces the price of those*

bonds. Since the market rate of interest on govermment bond is inversely related to their price since the nominal rate on them is fixed for the duration of their life, forcing the price of these bonds down increases the market rate of interest earned on them. This can be used by a central bank to support a policy that keeps market interest rates above those that the market would otherwise settle upon.
* *Reduce spending power in the economy by reducing the supply of government-created money in central bank reserve accounts. As a result QT can be described as an anti-inflationary policy.*
* *Draw funds away from private sector market-based investments, meaning that QT is likely to reduce growth in GDP.*
* *Reduce the size of the balance sheet of a central bank, which size is inflated by QE.*

As Larry notes, central banks have liked to represent the QT process as a purely technical exercise. They argue it reduces the amount of government-created money in the economy and so reduces the size of their balance sheets. It is also claimed that the process increases the overall date of maturity of government debt. Both arguments are technically right, and simultaneously both disingenuous and dangerous.

That suggestion needs explanation, and I do not apologise for being a bit geeky in what follows.

The first thing to say is that the size of a central bank's balance sheet is almost utterly inconsequential, unless it is too small. All that the size in question indicates is the amount of money that the central bank has created on behalf of the government for whom it acts to support the functioning of the economy for which that government is responsible. Let’s be clear: someone has to create that money. It is either the central bank or it is private sector banks that must do this, with the latter achieving this goal by advancing more loans, which increases the amount of private sector debt in the economy in question.

When deciding whether it is the central bank or private sector banks that will create the money the economy needs there are three issues to consider. One is the financial stability of the economy. Governments can always repay their debts in a country like the UK. Private borrowers cannot always do so. The more money the government creates the more stable an economy is likely to be as a result.

Then there is the need for a sufficient money supply to enable the transactions that need to be undertaken within an economy to take place. There is a basic liquidity need that must be met in an economy, not least between the banks themselves. Government must meet this need, and must most especially do so at a time when (as is the case now) private sector lending is likely to be falling because of falling house prices and lower business borrowing in a recessionary environment.

The other factor is managing the profile of supposed government debt, not that I accept that there is any such thing. Government debt his made up of three things:

* Government created money, or base money. This is in turn made up of two parts.

One is notes and coins. The other is central bank reserve accounts held by the commercial banks with the Bank of England. Please follow the link on that term for an explanation if you are not familiar with what these are.
* Cash based savings, like funds members of the public hold with NS&I. Yes, owners of Premium Bonds really do just have a stake in the national debt.
* Government bonds. Again, please look at the glossary for more explanation on this issue, but in essence a bond is nothing more than a fixed term deposit account held with the government, usually by pension funds, life assurance companies, banks and others, all of whom are also looking for a safe place to save money.
In other words, the national debt is either money or savings, and nothing else.

There are, admittedly, some twists. Utterly bizarrely the Bank of England pays interest on the money it creates for commercial banks to use when they don't pay interest on notes and coins and those same banks charge interest when they create money for customers. This illogicality could be resolved by simply stopping all or most of that interest payment on central bank created money, which change would not even require a change to the law. And second, government bonds can be bought and sold, unlike most bank deposit accounts, but that doesn't alter the fact that they simply are money held on deposit for a fixed period.

So what is the obsession with the age of debt about? It assumes four things.

One is that people want their debt repaid. The reality is, that they do not. That is why the national debt keeps going up.

Another is that the government won't be able to repay its debt when the fixed term deposits held with it become due. But that's absurd, because the government ultimately regulates the creation of all money in the UK, so of course it can always create the money needed to repay any debt it might owe. That's why we rely on its £85,000 guarantee for our bank savings in commercial banks: we know the government can always pay even when other banks cannot.

And then there is an obsession that issuing new debt may cost more than that which it replaces. Here the assumption is that markets set interest rates and governments do not. This is absurd: we know that rates actually move in line with central bank wishes - as the last two years have proved - so this worry is utterly irrational: if governments want to bring down rates they can.

The final thing that this claim assumes is that the government debt represented by government created money, held by commercial banks in their central bank reserve accounts, is repayable on demand by those banks. This in turn presumes that the banks in question voluntarily deposited these sums with the Bank of England, when, in practice, the sums in question were created for them by the government, over which sum the UK's commercial banks have almost no commercial control, in aggregate.

This suggestion is important, because whilst it is entirely true that commercial banks may use the balances in question to make payment to each other, they cannot in aggregate make any request to the government that the total sum held on such accounts be repaid. Whether or not such repayment takes place is a matter for the government alone to decide, and is determined by the decisions the government alone makes on the scale of the deficit, QE policy, and QT policy, none of which are under the control of the commercial banks.

It is, therefore, actually the case that far from central bank reserve account balances being repayable on demand, as financial commentators suggest, they actually have no fixed repayment date at all, and for all practical purposes can be considered to be of indefinite age, unless the government decides otherwise.

To therefore suggest that it is necessary to undertake QT to reduce the overall age of government debt, so deferring the date on which repayment will take place, is absurd: QT actually achieve the exact opposite outcome by replacing central bank reserve account balances, for which there is no fixed repayment date, with bonds, for which a repayment date must always be fixed as (I think unwisely) we do not allow the issue of non-repayable government bonds, which we once did and could do again.

What to conclude from all this? Four things.

The first is that QT is forcing up interest rates.

The second is that QT is massively increasing the risk of a recession because it is seriously reducing financial stability, contrary to the mandate the Bank of England has to create stability.

Third, if the Bank of England do not know this they are not fit to undertake the task entrusted to them.

Fourth, if they do know this but are doing QT anyway they are also not fit to undertake the task entrusted to them.

In summary: QT need to stop, now. Our financial stability, the decline of inflation and the chance of avoiding recession all depend on it.