Funding the Future

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In this morning's video I note that government bonds do not fund government spending any more than tax does. So, I ask, why do governments keep issuing bonds when there is no obvious need for them to do so?

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The audio version is here.

https://www.podbean.com/player-v2/?i=smibq-169998e-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=8bbb4e&font-color=&logo_link=episode_page&btn-skin=ff6d00

The transcript is:

Why does the government issue bonds to the savings market if it isn't necessary to do so to fund government expenditure, which it is not?

Now that's a really good question, but one that needs explanation if we are to understand how the UK government finances work and how the UK savings market works.

I've already explained that no part of taxation or borrowing funds government expenditure because literally all of UK government expenditure is funded in the first place by the Bank of England giving money on overdraft to the government so that it might spend in pursuit of its legal programs. That is literally what happens day in, day out in the UK government, and it's really very hard to argue with that because as a matter of fact it's true.

I've already discussed why we tax despite that. I have made a video on the six reasons why we tax despite the fact that tax does not pay for government spending.

But why, then, does the government appear to borrow by issuing bonds into the financial markets when it doesn't need to do so? That is really confusing because it ends up creating this narrative about the burden of national debt, which is beloved of so many of our politicians who believe that we are going to, well, hell in a handcart if you like, because we will not be able to repay this sum that the government has, in their words, borrowed, which word I don't agree with.

So, let me explain what the government does.

Once upon a time - and that is the right way to open this part of the explanation - once upon a time the government did have to borrow, because there was an artificial constraint placed upon the amount of money in the economy, and that artificial constraint was supposedly the convertibility of money into gold.

Now, there was definitely a finite amount of gold in any economy, and if that economy tried to produce money, including paper money, in excess of this value of gold that it held, then serious consequences arose, including the deflation of the currency on international exchange markets, which existed long before we got the 20th century, but also because there was a shortage of literal cash movement within the economy and convertibility, which was an essential quality that banks were meant to maintain.

Therefore, at that time, when this supposed requirement of convertibility of money into gold was in operation, and the government wanted to borrow, and it couldn't create more money because it couldn't get its hands on any more gold, it had to go into financial markets and literally secure the funds that it required from those markets by borrowing.

In that case, the tradition developed of the government issuing what were called gilts. They were only called gilts because the paper on which these bonds were printed had a gold edge to it. Hence the name.

And the bond was a savings instrument. Somebody could place their money in a government bond on a fixed date and on a further date, sometime in the future, they would get their money back. And in the meantime, they would get interest paid on it, usually twice a year. And rather curiously, in times of old, and again, I stress, I'm talking about ‘Once upon a time’ here, there were actually a series of coupons printed on the bottom of these gilts, and you clipped off your coupon, took it into your bank, who redeemed it for you, making a claim against the Bank of England, and therefore the Treasury, to be paid the interest in question. So, that's where we get the term coupon rate from.

But this is history, and history is not the same as what is happening now. We don't have a requirement to have money that is converted into gold now. We have what is called a fiat currency instead. And fiat, in this case, does not refer to a brand of Italian car. It refers to the fact that our currency is legal because the government has declared it to be so. And it is that declaration process that is the fiat. That makes the money legal tender. There is, therefore, no constraint on the amount of money that a government can create.

We know that because when we came to the 2008 global financial crisis, and when we came to COVID, the government created money at will to meet the needs of our economy. And thank heavens that it did so. Therefore, there is no such constraint now.

But, historically, what happened was that the whole edifice at the City of London, and all the banks located in it, got incredibly used to having these things called gilts available to them to save in.

And in fact, the big advantage of gilts for the banks was that they could place their money safely with the government who could guarantee repayment when they had excess funds available.

And the same pattern goes on now. Whilst you and I can save in a commercial bank and have the government guarantee our deposits up to the value of £85,000 for each bank we might save money in, if we are so fortunate, that is not true for companies who want to place billions of pounds on deposit, particularly when they have no use for them in what is called the overnight trade. In other words, they have no use for this money because it is not being used in their active trading during the course of the hours of darkness, and they wish to place the money on deposit, which is what they do.

But, there's no guarantee they'll be repaid. And since Northern Rock and then Lehman Brothers failed in 2007 and 2008 respectively, they know that even very large banks can go bankrupt on them. And if they did, they wouldn't get their money back the next morning. In fact, there will be a massive knock-on effect for the companies who have put money on overnight deposit with these banks, and, as a consequence, the companies in question could fail.

So, instead, there's a trade that goes on. What happens is that overnight, these large companies with quite probably billions of pounds of money to put on deposit overnight will buy government bonds from banks, keep them from literally late in the evening to early the following morning, and then sell them back to the same bank they bought them from. The price will change very slightly overnight and that increase in price will be the interest rate that's being paid.

But the critical point is that this provides the security for these companies to save safely in a way that they couldn't with the bank themselves. So, government bonds do in part exist simply to make the City of London work.

And that's true for other parts of the City of London as well. For example, pension funds need to match their very long-term liabilities to people who are going to live for a long period of time after they've reached retirement age, and they need somewhere safe to put funds to guarantee that they will be able to repay in 25 or more years’ time. Where do they put that money? Quite often, they put it in government bonds.

Life assurance companies will be in the same position.

And there's another group of people who particularly like buying government bonds as well. That is people who want to save in sterling, our legal tender, and they come from overseas.

Who are those people? Well, some of them trade here and they just want to hold sterling deposits to make that easier. We are, after all, still a major trading nation.

Others have made profits here and don't yet want to repatriate them to the country where they are. They will want to leave money here. They won't want to leave it on a bank account any more than will a UK depositor because they will suffer the lack of a guarantee. So, they buy sterling bonds as well.

And other governments want to hold sterling because sterling is still a reserve currency for the world and other governments therefore want to hold sterling balances and therefore they buy bonds too.

Now, for all these reasons, the government issues gilts still.

Does it do so because it needs the money? No, it doesn't need the money. As a matter of fact, it could simply borrow all the cash it needs to fund its programmes from the Bank of England, pay interest to them, which will go straight back to the government, and that would be the end of the story.

But they issue bonds instead because without those bonds the City of London, the pension market, the life assurance market, and the overseas international trade of the UK probably wouldn't be able to happen in the way it does.

So, bonds don't exist to help the government, because the government doesn't need help, it can create all the money it needs for itself. Bonds exist to let the financial markets work.

So, let's never pretend that the government is in hock to those markets, and that those markets can tell the government what to do. The reality is that those markets are utterly dependent upon the government to provide the savings mechanism that they need so that they can function.

The power is all with the government, never with the financial markets. It is time that our politicians recognise that, and we stop the nonsense that we are dependent upon these markets for money because we aren't, and we never will be.