Funding the Future

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The idea that bond vigilantes can set government policy suits the City and neoliberal politicians, who'd like it to be true. But is it?

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This is the transcript:

Are bond vigilantes really in control of how much the government can spend on things like poverty relief in the UK, or similar programmes in other countries, come to that? Is that really true?

If you listen to politicians in the UK, in particular, they would say that it is. They have to keep the bond markets happy, they say, as if we are utterly dependent upon these people to provide the money on which our public services depend. But that might just be their excuse to justify austerity and cuts. Their story is so misleading that it needs to be explored.

Who are the bond vigilantes anyway?

What is this nebulous group of people who apparently exist, who are so determined to ensure that the UK government cannot supply what people in this country want?

They, supposedly, are investors who are willing to trade government bonds in this country to protest about government policy. Their aim is to push up the interest rates on government debt so high that they will discipline the government into doing exactly what they want, which is, let's be blunt about it, austerity by any other name. What they're trying to do is, fundamentally, control the level of government spending by denying the government with cash.

The assumption which both the bond vigilantes, and it would seem the government share, is that the government is utterly dependent upon the financial markets to supply them with the money they need to make good the difference between government income, that is taxation, in effect, and government spending, which has over the last 25 years invariably been higher, and in fact has invariably been higher ever since 1694 when the UK national debt first arose. And, the assumption is that without bond funders' money, the government cannot function. They can therefore impose their terms on the government.

But is that true? I would argue that it isn't. I would, in fact, argue that all the power in this relationship is with the government, and is not with the bondholders at all, and that we need to reappraise this relationship to understand just exactly what is really going on.

Because, let's be clear, in the UK, the government issues its own currency, the pound. It is the only person who's authorised to create the pound. And yes, I do know that commercial banks create money by their lending, but they only do so because they've been licensed to undertake that activity by the Bank of England, which is of course owned by the government and regulated effectively by the government, which means that in effect, all those private banks are simply acting as agents for the Bank of England to create pounds, and therefore, ultimately, the government does literally remain responsible for the creation of every pound that there is in existence.

In that case, if the government creates all the money that we have, and it can never run out of money to pay its debts, precisely because it always has the power to create more money to settle any claim that arises upon it, because that's what owning the Bank of England does for it, then it isn't true, it is in fact impossible for it to be true, that the government is dependent upon bond holders to provide it with money to be able to fund its activities because they must have got their money from the government in the first place, and this is the fundamental truth that is being ignored by everyone who talks about bond vigilantes.

And we know that this argument is true.

We know that the government can create money.

We don't have to resort to all the silly phrases that are used by those who try to oppose this idea. All we have to refer to is the quantitative easing programmes undertaken by the UK government, both Labour and Conservative, after the global financial crisis in 2008, which eventually created no less than £895 billion of new money that was injected by the government into the economy without in effect bonds being issued because the bonds that were created as a consequence were all reacquired by the Bank of England, and therefore they didn't circulate within the financial markets. And, as a consequence, this was an exercise in pure money creation at the end of the day.

The reality was that after that crisis and during the COVID crisis, the government funded itself by, in effect, borrowing direct from the Bank of England, even if the quantitative easing process was used to disguise that fact. And, if you want to understand that in more depth, go and read it up on my blog where I do just that; I do explain it in more depth. But the proof of the pudding that quantitative easing provides is that market dependency is a complete and straightforward myth. It is not true.

In fact, the absolute reverse is the truth. The reality is that the government does not need to issue bonds because it can always create money to fund its activities. It doesn't want to do that on every occasion because if it spends in excess of the amount of revenue it gets, it could create inflation. And so as a consequence, what it did was create the possibility that people who ended up with that excess of government created money could save it with the government, as a result, effectively taking it out of circulation in the economy and therefore preventing it, creating inflation, because that's what savings do. They literally create dead money, which doesn't get used for current economic activity and which cannot, therefore, fuel price increases. So, government bonds were created for the precise purpose of ensuring that an excess of government spending over government revenue did not fuel inflation.

But at the same time, what was created was something which, whether by accident or design, was the safest place to store money, because if you save your money with the one and only agency in the UK who can never go broke because it can always create more currency to settle its debts, it is the safest place to deposit your funds, because they can never go bust and commercial banks can.

And the City of London, and others, know this.

Banks are major users of government bonds to underpin their business activities, in particular, the overnight deposit market that operates in the City of London.

And pension funds use them extensively to balance their liabilities with regard to paying people of my age and older who want an income for life.

And for the same reason, insurers who might insure a risk which is going to last for years use government bonds to provide stability to their financing.

In other words, the City is actually utterly dependent upon the government issuing bonds to ensure that they can undertake their activities.

They don't buy bonds to fund the government, as if that was a favour.

They buy bonds, which the government creates as favour to the City of London, and we have to understand that this is the actual relationship that takes place.

It is the markets who are dependent upon the government and not the government who is dependent upon the market, because bonds are not funding anything.

Remember that the money that is deposited in a bond has already been created by the government to fund its expenditure before it becomes surplus to someone's needs, and they therefore wish to save it, which is why they buy a government bond. So the bond doesn't fund the government. The bond provides a place of safety deposit for the funds already created by the government. Bonds provide the city of London with a secure interest-earning deposit in which they can store money.

And what we see here is the state doing something which is absolutely fundamental and one of its key roles within any society. It is providing stability to financial markets.

As a consequence, this whole idea that markets can somehow discipline the government is, let's be blunt about it, complete and utter nonsense. The reality is, and we have seen this throughout the crises after 2008 and again after the COVID crisis, is that in moments of crisis, bondholders, in fact, always want to buy government bonds because the government is the place of safe deposit, and that is fundamental.

But that fact also gives the Bank of England power over the economy in a way which is quite extraordinary because it can set interest rates, and we've seen that over the last five years.

This chart shows what has happened with interest rates over the last five-year period. When the Bank of England set interest rates very low, as it did in 2020 and 2021, market rates on bonds were very, very low. When the Bank of England pushed interest rates up to try and control inflation, market rates went up.

Now that the Bank of England is beginning to reduce its interest rates, we've got at least stability and some indication that on occasions they might fall, except for the fact that Trump has created instability in world markets. But the idea that there is any discipline from markets on the government being seen in this pattern of interest rates is absurd.

It just isn't there. And we know that's true. We know that governments can control rates because it did it with quantitative easing. The whole purpose of quantitative easing was, in fact, to bring interest rates down to near enough, nothing. That was the purpose, and the government could do this again. At any time if the market's got uppity and said that the government can't do what it's likes, the government could simply buy its own bonds again, just as at this moment, in an attempt to keep interest rates high, which is working and is one reason why the UK has interest rates which are in excess of those that are needed, the government is pursuing a policy of quantitative tightening, which is selling the bonds that it bought during the course of the QE era back into financial markets, even though that is totally unnecessary to fund government expenditure, because, of course, there is no relationship between the value of these bond transactions and government expenditure because government expenditure is funded by the Bank of England, so quantitative tightening is merely an exercise in controlling financial markets. The government is in charge.

In that case, the idea that austerity is imposed by the City is nonsense. Austerity is, in reality, a political choice, an ideology imposed by politicians, but not something that is imposed by the City.

So the reality is that if we had a decent government, they would understand this.

They would also understand that modest inflation is not a constraint on their activity, and might even be welcome.

And they would understand that government debt is not, as such, debt, but it is simply the accumulated savings of people who want to deposit funds with the government because it is a place that they trust. And the government should celebrate that fact and not say that it is a problem.

The real problem for the government is its failure to deliver full employment, because that is the real constraint on growth in the economy. And governments who are focusing on debt do not deliver what is required, which is employment for everybody at a decent living wage.

So, again, if governments understood that this was the goal, they wouldn't obsess about deficits because they're absolutely normal, and in fact are decidedly positive in many cases because they fund the investment that can fuel growth.

And in this case, I do mean they could fund investment because the government could create bonds that were specifically to be used as capital for the purposes of funding infrastructure. It's an entirely realistic goal for them to do. And as a consequence, they would turn savings into something which is a useful financial product, which is a relationship which hardly exists anywhere in financial markets at present.

But, in that case, who's got the power? As I've already pointed out, it cannot be the markets. It is the politicians.

And so, where are we? The time has come for a new narrative. Bond vigilantes are a myth. They're a myth that suits the City of London very well. They're a myth that suits politicians who want to fuel austerity very well. But both those myths are wrong. They are as wrong as the belief that there might be fairies at the bottom of your garden. They are as absurd as that.

What we actually need is a government who understands that they can use their power to influence interest rates, and to impact on the levels of demand within the economy, to also influence the level of savings within the economy, to achieve the goal, which is an economy that serves the interest of the people of this country, including by delivering full employment.

Let's stop pretending that markets are in charge. They aren't. The government is, and it requires politicians who understand that to deliver what we really need in this country, which is a government that puts things right.