Funding the Future

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I was a little surprised to find that I posted so much about bonds yesterday, because that was not my plan for the morning. However, I woke early, and that was how things turned out.

I admit, I have been thinking about the issue because so many people have asked me to explain what bonds (or gilts) are, how the bond market works, and why they can supposedly hold us to ransom. Precisely because of that commonplace claim, the series that I am intending to make once that on wealth is complete is on bonds.

I still think that is likely to be true, but the six-part series on this issue that I have been thinking about might need to expand now, because I now realise that I do not just need to explain how the bond market works, and why they need not threaten us, but also how that market can actually be, in very large part, replaced.

The Functions of the Bond Market

As I have said many times, the reasons why we have a bond market are numerous, and include:

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The need to effectively withdraw from circulation that part of government-created money that is injected into the economy and not reclaimed through taxation, if we are to control inflation.

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To provide the City of London, and financial institutions within it—including banks, pension funds, and insurance companies—with a safe place to deposit funds where they can be guaranteed repayment, which is something only the government can do.

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To provide a place for the secure deposit of funds that people from overseas wish to hold in sterling, which, again, is exceptionally difficult to do in any other way.

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To provide the necessary financial instruments that City of London banks can use to

operate what is called the repo market. This is the basis for overnight bank deposit facilities operated in London when UK companies wish to place billions of pounds that they are not using during the night on deposit until the early morning arrives. At present, there is no other way to do this but by these companies buying government bonds from banks in the evening, only to sell them back the following morning, with the price differential representing the interest paid. The reason why they will only deposit funds in this way is that they do not trust banks not to go bust in the meantime. The government bonds do, as a result, provide them with security against bank failure overnight.

Bonds Do Not Fund the Government

As I've often explained, none of this has, of course, anything to do with funding government activity—any more than taxation has anything to do with funding government spending. Government spending, in the way the structure of government funding has worked for a very long time, has always been funded by new money creation by the Bank of England. Tax and bonds create balancing consequential inward financial flows to neutralise that money creation within the macroeconomic financial cycle, but they do not fund anything.

That said, as I have also noted for a long time, whilst bonds fund nothing, their existence is fundamental to the operation of the City of London, and, come to that, of other financial markets where bonds of a similar nature are issued by other governments where other currencies are in use. Without bonds, those markets simply could not work. That is one of the reasons why the idea that we are beholden to financial markets is quite absurd, when it is glaringly obvious to anybody who wants to think about it that the financial markets are actually beholden to the government.

Again, as I have long said, it is also the case that interest rates on these bonds are not set by financial markets. They are—very odd occasions excepted—set by central bankers. So, for example, the reason why UK government borrowing costs are higher than those of other countries at present is not because markets dictate this, but because the Bank of England has, both by setting rates too high and then, by the use of quantitative tightening, reinforced those excessive rates. The reality here has to be understood, and it is too often ignored or pretended to be other than what it really is.

The Change in My Thinking

That is my preamble, and in offering it, I have not covered all the issues that a series on bonds would address. The rest will have to wait, though, because at this point, let me suggest where my thinking has changed since yesterday morning—because it most definitely has in several ways.

Direct Saving for Social Investment

Again, as long-term readers of this blog will know, I have long promoted the idea that the government should offer direct savings mechanisms to those in the UK who want a safe place to put their money—without there being a deposit guarantee limit—knowing that the funds that they deposit would be used for a social purpose. (See page 281 and following **here**).

I have suggested that bonds might be issued to fund the green transition, the NHS, education, health, social housing, and other programmes—all of which are capable of generating returns either directly or through multiplier effects, which is a consequence the government should be more than willing to underpin through guarantees of safe return.

The purpose of these instruments has always been quite different to that which government bonds have been meant to fulfil. The intention is that they should promote new, real investment in the economy that will deliver a social return. I have suggested the idea of hypothecation of funds because I think that this would appeal to savers, and I think they should have some choice on this matter, whilst accepting the government would still have the job of making up shortfalls in critical areas if savings were not forthcoming.

These savings are not, then, intended to be used in the way that government bonds are, which is to take money out of circulation. They would be quite deliberately promoted with the intention of putting more money into circulation by re-creating the relationship between savings and investment—if a strict taxonomy (which simply means regulation that defines what might be invested in) was created for these bonds, and so use for social purposes could be guaranteed.

Mobilising Existing Savings

If, as I previously suggested, all ISA savings were now required to be deposited in such funds, and 25% of new pension contributions were required to be saved in this way, then more than £100 billion a year is likely to be available for investment in the UK economy as a consequence. The macro data on savings in these instruments suggests that there will be ample liquidity to cover movements arising from withdrawals.

Promoting this idea is not new. What is new is suggesting that these bonds should be made proactively available as an alternative to saving through the products now offered by commercial funds, when those commercial fund operators are doing three things which are failing savers:

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Firstly, they are threatening our government, which is undemocratic.

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Secondly, they are refusing to invest in those things that are essential to guarantee

that we have a future, which is contrary to the best interests of savers.

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Thirdly, they are exploiting savers by extracting excessive rewards.

Turning Savings into Investment Funding

In other words, what I am suggesting is that some of the funds now deposited by financial institutions in government bonds that have had the macroeconomic effect of simply balancing the money supply equation to control inflation should be diverted into positive macroeconomic activity that will have microeconomic consequences, with the intention of ensuring that more desirable investment takes place.

Of course, the necessary corollary of using savings as active money to fund investment, rather than to deposit them in passive accounts, which is what happens at present, is that the money supply equation within the overall economy could become unbalanced. There could be too much money being used for constructive purposes unless money was extracted from that economy in some other way, to which the obvious answer is that if we are to fund investment in this way, then we very obviously need to tax wealth in all its forms more. Although, as usual, I am suggesting that this should be by taxing the income gains derived from wealth, rather than wealth itself. This does not mean wealth will fund investment, of course: it means it must be taxed to maintain economic balance.

Questioning the Need for Bonds

I am, however, thinking beyond this issue and how bonds work now, and am now beginning to ask the question: why do we even need bond markets now? Aren't they simply an anachronism from a past era that we could at least to some degree do without?

For example, whilst I can see a continuing use for bonds for some purposes, direct saving in government-issued bonds of the type that **Clive Parry has described on this blog could diminish the role of structured pension funds—I think with obvious benefit—because it is not clear how they are now delivering value in the economy, which is a point on which even Rachel Reeves would agree.**

Rethinking the Repo Market

And then there is another issue, which is why it is the government's job to provide bonds to the City to undertake activity in the so-called repo market, when in practice, the problem that this market exists to tackle is the lack of confidence that business has in banks. That could be overcome by simply allowing large companies to place funds which they wish to deposit overnight directly with the government. I accept that there is an issue here in determining just what it might be that the government might wish to pay interest upon, and why, but if the primary reason for the repo market is not the generation of a return, but is instead the seeking of security, then why shouldn’t the government provide this directly?

Maybe, for the first time, I can see a reason for a digital currency. This idea needs further exploration, and I’m not pretending that I’ve done all that thinking as yet, but there has to be merit in exploring this.

Alternatives for Overseas Investors

Then, if such an account were created to eliminate the waste of resources currently dedicated to managing the repo market, why shouldn’t the same type of account be made available to those who want to hold significant quantities of sterling but are based overseas? In other words, why couldn’t the Bank of England offer a digital currency account to such people? Why use gilts for this purpose? Isn’t there a better way to manage this activity and eliminate yet more wasteful bank activity from the market in the process?

A Vision for Reform

Thinking in the above way has suggested that three of the four major uses for bonds can be replaced with potentially more efficient and effective mechanisms better suited to user needs. In summary, then, the goal of my thinking on this issue at present is, in that case, to suggest the following things:

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Firstly, we can fund more investment, which is absolutely essential if our economy is to be adapted to meet the needs of the people living in this country, if only we change the way in which we save, and most especially the bond market.

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Secondly, the corollary of this might be a need to increase taxation of wealth, but I stress that does not mean that the taxation in question does fund the investment. As ever, the tax will be there to balance the macroeconomic financial cycle.

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Thirdly, if appropriate savings vehicles for pensions were created, the power of the City could be significantly diminished, to the great advantage of democracy in this country. That could be reinforced by the effective ending of both the overnight repo markets and the sterling deposit facilities market through the provision of direct facilities with the Bank of England.

A consequence would be that the supposed threat that the financial markets pose to the government could be very largely, or entirely,

eliminated—meaning that the political economy of this country would be radically transformed, and all of this by simply imagining that we can end a market that was invented in the 17th century, and which has long outlived its socially useful purpose.

Isn’t it time to explore that?