MMT and rules of government borrowing

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A new commentator left the following comment on this blog after my most recent video. They started with a quote from me:

'And bonds in particular behave very differently in the MMT worldview. These aren't debts. These are simply money put on deposit with the government, because that is the safest place for people like the City of London to save.

There isn't, therefore, an obligation to make repayment because these are voluntary arrangements between what is in effect a banker – the government – and those who've got surplus money that they wish to find a home for.'

Then they asked for an opinion on it before asking a pertinent question:

On the assumption that we are talking about govt treasuries ('bonds') doesn't the govt. issue these to banks (through the Central Bank) to match its fiscal deficit and don't these get further bought/sold by domestic and institutional investors which then determines the price/yield on these on a day-to-day basis? So, isn't there a sovereign obligation for the govt. to repay the principle and interest on these debts? And, doesn't that then place a check on the amount of the fiscal deficit which a govt can safely run? Isn't that what happened in the UK in 2022 after the 'mini-budget' when the govt announced a slew of tax cuts and additional expenditure proposals, which sent the bond/treasuries market into a spin?

That question is fair, but I would suggest that some of the assumptions in it are misplaced. That needs explanation, hence this blog post, because this seems of wider interest.

First, matching deficits with bonds is a chosen rule, not an economic necessity.

The UK government has not always issued bonds to "cover" its deficit. Until 2006, it also made use of the 'Ways and Means' account it held at the Bank of England. This was, in effect, an overdraft facility. Government spending was financed directly by the

Bank, as always, and bonds were only issued if there was a policy reason for doing so; in other words, if circumstances were right, monetary policy required it, or there was demand to provide safe assets for financial markets. Flexibility was the watchword.

It was only after 2006 that the Treasury and the Bank of England essentially agreed to end routine use of the Ways and Means facility and move to a system where deficits were matched by bond issues of varying types, from very short-term Treasury Bills to long-term gilts. This, though, was not an economic necessity. It was simply a political choice to change the convention of the monetary regime. Nothing in the nature of money or government finance required the new arrangement, excepting, perhaps, the Maastricht Agreement, which no longer applies in the UK.

Second, there is no requirement to pay interest on borrowing from the Bank of England.

Since 2009, the Bank of England has purchased hundreds of billions of pounds of government bonds under its so-called quantitative easing programme. At one point, it owned more than a third of the entire stock of government debt, and it still owns around £700 billion of that debt.

Those bonds are assets of the Bank of England. But the Bank is part of the government. There is no external creditor here. There is, therefore, no economic necessity for interest to be paid on those bonds at all. If the Treasury and the Bank wished, they could agree that such payments should cease, because in reality they are nothing more than money being shifted from one arm of government to another. It is a political choice by successive governments to still pretend that these interest costs exist, when in fact they are then returned to the government as income.

Third, paying interest on central bank reserve accounts is also a choice. Commercial banks are required to hold reserve accounts at the Bank of England. These are the balances that make the payment system function. Since 2006, the Bank has chosen to pay interest on these reserves. But again, that is a choice. The Bank of Japan and European Central Bank do not pay interest on all their reserves: other models are available, in other words. The Bank of England could follow their example. There is no obligation to continue.

So where does that leave the question of "sovereign obligation"? Of course, when the government issues bonds to private savers (and I stress, that is what they are: they are not investors because the government is not dependent on the funds received to undertake its activities, since they have already been paid for by the Bank of England), it undertakes to repay them at maturity, with interest. But that is the product of a set of rules which the government itself has chosen to create. But, as I note, the government could fund itself without issuing bonds. It could fund itself without paying interest. It could, if it wished, change the terms on which bonds operate. In other words, this totally artificial human construct called the bond market can have the rules under which it operates, and even the understanding of why it operates, altered if the political will to do so existed. As a consequence, there need be no hard, external “brake” imposed by markets on the government’s fiscal capacity. That there is a pretence that such a brake exists is the consequence of neoliberal political policy choices, and nothing more.

So, what about 2022 and the Truss “mini-budget”? That is the inevitable response to such suggestions these days. My suggestion is that a bond market sell-off occurred after Kwasi Kwarteng announced his tax-cutting budget in 2022, for which he provided no funding details. However, it is essential to understand what actually happened.

The prevailing media narrative was that markets simply “lost confidence” in the government’s fiscal numbers. But that is not the whole story. What really tipped markets into crisis was that the Bank of England's announcement the day before Kwarteng spoke that it was going to start proactive quantitative tightening, or, in other words, it was going to begin proactively selling off government bonds it already held as a result of acquisitions after the global financial crisis and during the Covid period.

That decision to flood the market with gilts at exactly the moment the government implicitly also announced a significant increase in bond issuance as a consequence of the tax cuts it was planning created a perfect storm. Yields rose sharply. Pension funds, which had used complex leveraged strategies tied to gilt yields, suddenly faced margin calls they could not meet. A wave of insolvencies was threatened in the UK pension sector.

The Bank of England was forced to intervene within days with an emergency bond-buying programme, effectively extending quantitative easing as a result, to stabilise the market.

This episode demonstrated not that the UK government “ran out of money” but that the Bank of England’s own actions in managing the bond market can create or relieve a crisis. In other words, it was the central bank’s mismanagement of money creation and destruction that caused the meltdown, proving just how important government money creation really is.

What to conclude then? The real point is that claims that governments must always balance deficits with bonds, and that they must always pay interest on those bonds or on central bank reserves, are false. These are conventions of the last twenty years. They are not natural laws. Once we understand that, we can see that the government’s real limits are not set by “bond markets” but by the actual resources available in the economy - the labour, skills, energy and materials we can bring to use – and by the inflationary pressures that might arise if spending exceeds those real capacities. That is what MMT has always said. And it is why I continue to argue that we need to stop treating self-imposed accounting conventions as if they were laws of nature. They are not.