Glossary entry: bond vigilantes

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I have added this entry to this blog's glossary at the request of some commentators. I stress that in an area as complex as this, the entry can only be an outline.

Bond Vigilantes

The term "bond vigilantes" was almost certainly coined by financial journalists seeking a bit of drama in their otherwise humdrum reporting. The term they invented makes markets sound as if they share plots with Clint Eastwood films.

Supposedly, bond vigilantes are investors who “punish” governments they dislike by selling government bonds and driving up interest rates. As a result, it is suggested that they determine which governments are “responsible” and which deserve market retribution.

There are several problems with this story.

First, who are they?

So-called "bond vigilantes" are employed by some of the world's most prominent financial institutions, including pension funds, insurance companies, asset managers, and banks. These are not heroic outsiders standing up for truth. They are the same institutions that have profited massively from the neoliberal order over the last forty years, and in the course of their routine activities, they buy government bonds because they need safe assets in which to save funds on behalf of their clients. They then sell them again when they get spooked (which appears to happen regularly) or when they can make more money elsewhere. There is nothing noble or democratic about any of this.

Second, what do they actually do?

These traders buy and sell. They speculate on interest rates, inflation and central bank behaviour. And, when they sell bonds in large quantities, the market price of bonds falls. A falling price equals a rising yield (for an explanation, see the glossary entry on bonds). The media interprets that as markets “losing confidence in government policy”. The reality is simply that investors are making a calculated bet that they can profit from forcing up the cost of new government borrowing.

Third, how do they do it?

Traders exploit a system in which governments pretend to “borrow” their own currency from financial markets, although in reality, when a currency-issuing government sells bonds, it is not accessing money it does not have. It is, instead, swapping one form of government money (bank reserves) for another (bonds). But as long as governments maintain the fiction that they depend on these markets to fund public services, the traders hold power. They can create a sense of crisis because politicians are terrified of interest rate rises that they think they cannot control, even though they actually have the power to do so.

How, then, do traders create the impression that they might, instead, be in control? This is where the tools of highly leveraged speculation come into play. Traders do not wait around to see if prices fall. They deploy techniques that can push prices where they want them to go:

* ***Short selling bonds.*** Traders borrow bonds they don’t own, sell them quickly and hope to buy them back cheaper later. Selling into the market drives prices down, creating the appearance of a confidence crisis.

* ***Betting through derivatives.*** Interest rate futures and swaps let traders wager on central bank policy, whilst credit default swaps let them bet on rising default fears, if they exist. These instruments can be leveraged many times over, magnifying tiny shifts in sentiment into large financial consequences.

* ***Coordinating the narrative.*** Institutional trades often move alongside media briefings about governments being “reckless”. The market move creates the headline. The headline reinforces the market move. The ethics are decidedly dubious.

* ***Leveraging every pound.*** By borrowing repeatedly, a fund with £1 billion can take positions worth £10 billion or more, albeit by creating considerable risk for itself.

The important point is this: none of these activities actually depletes the government’s capacity to spend its own currency. They simply increase the price the government agrees to pay to maintain the illusion that it needs the markets’ favour, when nothing can be further from the truth.

Fourth, what is their goal?

Profit. Nothing more. The moral language imposed around this activity is theatre. The suggestion that traders are "holding governments to account" is self-serving ideology. If bond vigilantes really cared about economic sustainability, they would not have been silent during the years of austerity that trashed public health, investment and growth. What they want is a world where governments obey the rules that preserve financial wealth over public well-being.

Fifth, why does this matter?

This all matters because the myth of the bond vigilantes has been used to enforce austerity, weaken democracy and undermine public services. Politicians claim that "the markets" will punish them if they spend to meet social and environmental needs, yet the Bank of England has shown that interest rates are not dictated by traders. They are set through monetary policy choices, and during crises, central banks buy bonds simply to keep interest rates down. The supposedly unstoppable vigilantes are always silenced whenever that happens.

Sixth, the real lesson

Bond markets only gain power when governments choose to fear them. A currency-issuing government can always pay for the services, infrastructure and care that society requires. It can always ensure that interest rates reflect social priorities rather than speculators' demands. The idea that markets sit in judgement on democracy is not an economic fact; it is a political choice.

In summary:

Bond vigilantes are not guardians of economic virtue. They are traders exploiting a system designed to give them leverage over democratic decision-making. The only way their grip loosens is when governments remember that they, not markets, are the ultimate creators of the money on which those very markets depend.
