

## Modern monetary theory isn't "just theory": it de...

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People ask whether modern monetary theory is "just theory". I think that's the wrong question. The real test is practical: does the UK actually operate as a modern money economy?

In this video, I walk through the plumbing: Parliament authorises spending, the Treasury instructs the Bank of England, payments are settled through reserves, and only later do taxes and gilts come into play. That sequence matters because it tells us something uncomfortable but vital: austerity is a political choice, not an economic necessity.

I also set out the real constraints: not "running out of money", but real resources:

- \* labour,
- \* energy,
- \* materials,
- \* skills, and
- \* technology

and that inflation and climate limits should guide policy.

If we get the ordering right, we can finally have the debate we should have had all along: what do we need, do we have the capacity, and how do we manage inflation fairly?

<https://www.youtube.com/watch?v=8u0EMtIIMJI?si=t5UMBPIO3taVdh04>

This is the audio version:

[https://www.podbean.com/player-v2/?i=52mrj-1a59c6b-pb&from=pb6admin&share=1&download=1&rtl=0&font=Arial&skin=f6f6f6&font-color=auto&logo\\_link=episode\\_page&btn-skin=c73a3a](https://www.podbean.com/player-v2/?i=52mrj-1a59c6b-pb&from=pb6admin&share=1&download=1&rtl=0&font=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a)

This is the transcript:

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People ask me whether modern monetary theory is just a theory, but that's not the right question to ask. The real question is this: does the UK actually operate in the way modern monetary theory says a modern money economy works? Does spending actually come first in this economy of ours? And is it true that neither tax nor borrowing funds the UK government? Because if those things are true, then austerity is a political choice and not an economic necessity, but just as importantly, MMT is already here, and I stress this is not about ideology.

What I'm talking about in this video is the real plumbing of the economy that we actually have, and in the process, what I want to test are five things:

- \* What happens when the government spends?
- \* What role does the Bank of England play?
- \* What are gilts - government bonds - actually for?
- \* What do taxes do in practice?
- \* And what are the real constraints on economic activity in this country?

So, what am I really asking? It is, if reality matches MMT's description? And if so, we do in fact live in a modern money economy, and that's a really important question because if so, we should be understanding how we should manage for the fact that that is what we do.

So let's look at the steps.

First of all, step one is that Parliament authorises all government spending. Let's just stand back. People presume that there's a debate about whether taxes have to be raised before spending, or whether borrowing has to be put in place before spending, and which comes first, spending or tax, but the truth is, all government spending starts with authority from Parliament.

Without that authority, the government cannot spend. We talk about budgets as things that change taxes, and that's what the focus is when we discuss them, but the truth is,

a government budget is not really about taxes at all. It's really about authorising the government to spend on the NHS, on schools, on social security, on infrastructure and everything else that we know we rely upon. That is the process which allocates the money to a government department from which it can then authorise the Bank of England to make a payment. Without there being a proper budget, there is no functioning government money system in the UK. But we do have budgets, and that is why.

So the budget is real control. We don't have to find money once the government has decided to spend. We don't have to worry about bond markets once the government has decided to spend. Nor do we need to worry about tax receipts because spending is authorised by Parliament, politically, first of all, and once it's been authorised, we should understand that the government has the power to then take step two in this process.

Step two in this process is that the Treasury instructs the Bank of England to make a payment. Once Parliament has authorised spending, the Treasury can simply send a note to the Bank of England, "Please make a payment of a pension to", well, me if you like, because I'm an old age pensioner. It can't send that note without Parliament having written that instruction, first of all. Of course, it does it generically; it doesn't make specific reference to me or you, if you happen to also be a pensioner, or you, if you happen to be a teacher. But the point is the budget out of which that payment is made has been authorised by Parliament, and this is, if you like, the operational moment.

The spend takes place because the Treasury authorises the Bank of England to increase its overdraft, and as a matter of fact, every day the Bank of England does run an overdraft for the government. It lends it money, and that is how money is spent into the economy by the government. That is how it creates money. We've been through this process many times before on this channel, and no doubt, we will do so again because it is something that people find hard to understand. But unless Parliament authorises the spend, the government cannot create money, but once it has authorised the spend, it can, and it's totally legal to do so.

The critical point is, when looking at this process, no one waits for tax revenue to arrive because, and this is vital to understand, until the government has spent, there is no money to tax.

And no one phones the bond markets for permission before they decide to pay me my pension. That is not what happens, because the instruction from the government through the Treasury to the Bank of England comes first, and that is critically important because then the Bank of England does, literally, in step three of this process, make the payment.

And when the payment is made, the government in effect credits the recipient's bank

account. In other words, money turns up with me, and again, I'm going to use me as an example. Every month, roughly a thousand pounds turns up in my bank account from the government, because I'm an OAP.

In the process, the payment is made from the Bank of England to my bank. My bank happens to be the Nationwide. So the Nationwide receives an increase in its central bank reserve account from the government, and at the same time, the government tells it to create commercial money making the payment on to me. Government money becomes commercial money as a consequence of the payment made.

But what happens is, the money supply increases. The government has, in effect, created cash in the economy, and I am better off because the government has spent, and always remember that. Government spending, which is funded by a deficit, an overdraft at the Bank of England when the payment is initially made, reduces the wealth of the government, but it increases the wealth of the private sector.

And this is what currency issuers can always do. They can make the rules that require that banks will pass money on to people like me, accepting the money that the government has created in the process. And as a consequence, quite literally, the UK state can never run out of pounds, any more than a scorekeeper at a game of cricket, football, baseball, whatever else you want to watch, can run out of points; it's just not possible.

So what is step four? Well, step four is this: when the government spends, banks hold more reserves. I've already mentioned this, but it's always worth reiterating these points because they are hard to understand. I realise that. When the government authorises the payment of my old age pension, it has to give the Nationwide the money to then pass it on to me. How does it do that? It increases the balance that the Nationwide holds with the government. That is called the central bank reserve account that it maintains with the Bank of England. But, and let's be clear about it, central bank reserve accounts are very important, and there's something like £700 billion in them at present, but they have more than one function.

They are used by the banks to pay each other. So if I then spend out of my pension and make a payment to somebody who banks with Lloyd's, then the Nationwide pays Lloyds through their mutual central bank reserve accounts. That's how interbank payments take place in the UK; the Bank of England is banker to banks.

But there's another role for central bank reserve accounts as well, and that is that they are part of the government's money management system, which keeps the economy under control.

So the government sells gilts and collects taxes, and the inward flows of money from taxes and from bond sales, gilts, if you wish to call them, that flows back to the government through the central bank reserve account, and that is how the money that

the government spent to pay me my old age pension gets back to it. Through tax payments, not necessarily by me, although I am a taxpayer, and by other people, and also by the sale of government bonds.

But, and again, I make the point, there is another reason for the central bank reserve account because the central bank reserve accounts exist to indicate what interest rate the Bank of England wants to operate in the economy, whatever they're willing to pay on the central bank reserve accounts, which is their base rate. If you wonder why that thing exists, well, that's what they pay on the central bank reserve account. That's what they're willing to borrow and lend at, and that is how they indicate to markets what the interest rates should be. So never doubt that the government has control over the interest rates in the economy, because it has.

And there's one final purpose for central bank reserve accounts because they do provide the economy with liquidity. We need enough liquidity in the economy. We definitely don't want too little because that requires that there be far too much private debt, and that is always dangerous for economic stability, but the government has to play a fine line again. It has to decide how much liquidity will it supply and how much will it take away, and that is partly what bond operations are about.

So bonds don't exist to fund the government. Bonds exist to help balance the liquidity that is available in the banking system. That's their purpose. It is not about government funding. So this is monetary policy housekeeping. It's about interest rates, and it's about portfolio choices, and it's not about funding the government.

So, what's step five in all of this? Well, that is the issue of government bonds. Government bonds are issued for a number of very good reasons, none of which have anything whatsoever to do with funding the government.

First of all, government bonds are issued to provide savings markets with safe assets. If you want to put £1,000,000,000 on deposit, and some banks, and some companies will, the £85,000 (*\*this should be £120,000*) guarantee that the government supplies on a current bank account is not too good, it doesn't exactly protect you. But if you buy government bonds, you've got a safe asset because the government has never defaulted on a bond payment.

So government bonds primarily exist, more than anything else, to provide those with a great deal of money, whether they be banks, or pension funds, or life insurance companies, or very large companies, with a safe place to put their money.

They are just savings accounts. Never forget it. That's all they are.

But as a consequence, because they're so big in terms of overall value, well over £2,000,000,000,000 worth, the rate of interest paid on government bonds does, again, influence the rate of interest within the market as a whole, and that's precisely why the

government wants them to be in existence. It wants to influence those interest rates because it wants to manage the economy. In the process, therefore, gilts are issued to assist pension funds, life insurance companies and finance markets and all of that with the goal of setting interest rates at the right point, the government hopes, to keep the economy in balance.

And let me stress one very important thing. Bonds are just a swap of one type of government liability, short-term central bank reserves held by banks, for another, longer-term bonds.

There is no new money created by a bond issue. All that happens is that cash held in central bank reserve accounts is given back to the government, and in place, the bondholder is issued with something which will pay interest over a longer period of time. It's like swapping money out of your current account into your savings account. We are back to savings accounts again, and that's it. You've given up literally a short-term source of money for a long-term source of money. No new money is created by issuing a government bond. It is an asset swap, but nothing else.

Bonds never fund government spending capacity, and why is that? Well, that's because the spending capacity is completely independent of tax and bonds, and that's because the government creates all the money it spends at the time that it puts it into circulation by running an overdraft at the Bank of England. It can't need two ways of funding one spending, and the only mechanism it uses to fund spending is a Bank of England overdraft arrangement.

So let's just talk about step six in this process: taxes happen later.

When tax is paid, bank deposits fall. When I have to pay my tax as a self-employed person, and I do, I have to literally make a payment to HM Revenue and Customs. It goes through a bank, it goes into the central bank reserve account. My bank account falls in value. The government central bank reserve account balances fall with the clearing banks through which it was paid. In other words, the Nationwide handles my payment and sends it onto the government, and its central bank reserve account falls as a consequence. There is less money in the economy. It's the exact reverse process of when I get money from the government that increases my well-being; paying tax reduces my financial well-being.

So paying tax is simply a process of taking money out of the economy. That's it, and there are real economic consequences.

Of course, the liquidity of markets is reduced, and therefore, the government has to take that into account. It has to make sure that there's enough money left in the system to make sure that the economy can work. And that's precisely why most of the time, the government does not choose to tax back exactly what it spends in, because a growing economy needs more money to make it function, and therefore it cannot tax

back as much as it spends into the economy, because there wouldn't be the cash available to make the economy work.

In that case, well, we've already noted, it issues bonds instead, because somebody eventually saves the excess cash.

But let's be clear about this. Issuing a tax demand does two things. First of all, it creates demand for the currency. You've got to have the pound to be able to pay the tax bill that the government has created. The tax bill does not fund anything. It's just there to actually demand money from you, to take money out of the economy. And that reduction in your spending power is essential to control inflation, which is the second key purpose of tax. Tax makes government spending sustainable in other words: it actually makes government possible as a result, but it doesn't operationally finance it.

So, let's go back to my original question: does the UK, in practice, use what is, in effect, modern monetary theory? Let's look at the sequence.

- \* Parliament authorises spending: tick, that's modern monetary theory for you.
- \* The Treasury then acts on parliament's instruction and instructs the central bank to make a payment: tick, that's modern monetary theory for you.
- \* The Bank of England then settles the payment out of a government overdraft, not out of anything else, and: tick, that's modern monetary theory for you.
- \* As a consequence, central bank reserve accounts are adjusted: tick, that is modern monetary theory for you.
- \* And after all that has happened, the government either taxes to reclaim money: tick, that's modern monetary theory, or issues bonds to mop up any remaining money that it wishes to provide a safe haven for: tick, that is what modern monetary theory says.
- \* In other words, the UK government spending and fiscal cycle works exactly as modern monetary theory describes. That's not because of ideology. That's just because MMT describes how the system we actually have in use really works. We already live in that case in a modern monetary economy.

So why do politicians deny this? Well, that's because admitting it would mean that they would have no excuse for austerity. They would have no excuse for underfunding public services, and they would have no excuse for rising inequality. And very bizarrely, our politicians are wedded to those three things because they believe in the household budget analogy, and if they actually saw through it, they would realise that they have been selling myths, and that would make them look very stupid, and that's the last thing a politician wants to be.

So, they are willing to compromise themselves to protect the institutions of wealth and power which exist, which are based upon this mythology, and we will pay a price as a

result. They would rather use falsehoods than admit how money really works.

But does that mean that we can spend money without constraint? No, of course it doesn't. That would be ludicrous. There's no point in spending money, creating money, trying to buy things if they don't exist. Real resources are the constraint on the amount of money that the government can spend into the economy.

What are the real resources in question?

- \* Labour.
- \* Energy.
- \* Materials.
- \* Skills.
- \* Technology, and let's be clear about this:
- \* Climate change. You don't want to spend in a way that is to promote a disaster down the line.

The risk of inflation is also there when you look at all of these things. If you reach a limit on buying any of those things, then the risk of inflation is real. So you should stop creating money.

So, the right policy debate is, what do we need? Do we have the capacity? And how then do we tax and regulate to stop inflation? That's the real ordering.

Let's just repeat that, the real ordering of economics, the real debate we need every time we discuss a budget is:

- \* What do we need?
- \* Do we have the capacity?
- \* And maybe you could ask, can we create it, of course?
- \* And then, how do we tax and regulate to stop inflation?

That is the reality of economics.

So what are the consequences? If we accept that reality, we could fund the NHS, social security, the green transition, housing, education, and so much more. The issue is of planning resources and managing inflation fairly, and not pretending that the UK is a household.

So let's come to a conclusion.

Are we living in a modern monetary economy? Of course we are.

Does MMT, modern monetary theory, describe what really happens in the UK economy? Of course it does.

The real political question then is, how do we use this capacity and this understanding to build a politics of care instead of a politics of destruction?

My answer is we talk about it.

You have to talk about it as well.

Every time you hear someone say, "How will we pay for it?", you have to ask instead:

- \* Do we have the people?
- \* Do we have the resources?
- \* How do we manage inflation fairly?
- \* And then demand tax justice.
- \* Demand investment in people.
- \* Demand democratic accountability, because understanding money is the first step to changing the economy, and we need a changed economy.

We have all the mechanisms in place. We could do what we need. That's critical. The point is our politicians refuse to understand what they're actually managing, and that's why they're making such a mess of it. What we need are politicians who will get their heads around the way the economy really works, and then we can be liberated to have the world we want.

That's what I think. What do you think? There's a poll down below.

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## **Poll**

[poll id="337"]