Funding the Future

It's time the media admitted the City needs bonds and n...

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My old friend, Larry Elliott, former economic editor of the Guardian, had an article in that paper yesterday in which he said (and I do not apologise for the length of the quote):

Faced with a new cost-of-living crisis, the government has a dilemma. There is a mismatch between what would be popular – subsidies to reduce energy bills, for example – and what the Treasury thinks the country can afford.

In theory that dilemma should not exist, because a government that issues its own currency has no limits on what it can spend. In practice, though, governments submit to the discipline imposed on them by the financial markets. There is no such thing as the Bond Dealers party, but there might as well be, because the people who trade in UK government debt exert a stranglehold on politics.

He added:

It works like this. The government sells bonds to investors in order to finance its borrowing. The investors are paid interest, which varies according to the risk involved. The higher the risk, the higher the interest rate investors demand. The risk can come in a variety of forms. It may be that the bond markets fear that inflation is about to rise sharply. Sometimes the perceived risk is political, with concerns that a government pledged to financial probity will be replaced by a spendthrift administration.

Markets currently believe the UK faces both these risks, which is why the interest rate – or yield – on government bonds has risen above 5% to levels not seen since the 2008 financial crisis and higher than in any other G7 country.

Larry might be a friend, but there are a great many things on which we have never agreed, from Brexit onwards, and I think Larry has much of what he says in this article wrong.

First, the idea that the government “sells bonds to finance its borrowing” when, as Laryy acknowledges in a nod to MMT, that is misleading because "a government that

issues its own currency has no limits on what it can spend" is wrong. Bond issuance in that case is always a policy choice, and not a funding necessity.

Second, the notion that bond markets impose a “stranglehold” is, as a result, overstated or just wrong. The Bank of England is the ultimate rate setter in the UK economy, if it chooses to be. Yields are influenced by markets, but they are not beyond policy control, as evidence has clearly shown in recent decades.

Third, the discussion of what Larry calls “risk” is misplaced. UK government debt is denominated in sterling. The government cannot be forced to default in its own currency. The real risks are inflation and resource constraints, and have nothing to do with insolvency. The government in this country has never defaulted on its debt since it began in 1694. There is no chance of it doing so now. There is, as a result, no "risk" in UK government debt, or any risk premium needing to be applied to it.

What is actually happening is political. The reality is that the UK Treasury chooses to behave as if it were financially constrained, markets then respond on the assumption that this is true, and market commentators like Larry work within that framework, as if it were real when it is not. That is not because the supposed financial constraint is an economic reality. It is, instead, a self-imposed limitation adopted by those who wish to limit government activity in the economy.

In reality, the government borrows nothing from financial markets. It does, instead, accept deposits from them, for which the City needs a safe location, which only the government, with its perpetual ability to repay, can provide. This is explicit in the case of central bank reserve accounts. It is also true of bonds.

The straightforward fact is that the City needs government bonds to operate, and cannot do without them, but the government does not need to issue them to function, as it can always create its own money supply. Recognising this fundamentally changes the power relationship between the City and the government. This is the reality Larry ignores, perpetuating, in turn, the myth of borrowing and a supposed City stranglehold on government action.

In that case, the supposed dilemma between what is popular and what is “affordable” is artificial. The real question is whether the economy has the capacity to absorb additional spending without inflation. In that case, so-called "borrowing", or the myth that it even exists, is no constraint at all, which Larry should have said, in my opinion.

In that case, the government could act. Markets cannot stop it from doing so. And if it chooses not to, that is a political decision, not one dictated by bond traders, and political leaders should be held accountable for that failure.