Funding the Future

Why does the government sell bonds?

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Why does the UK government sell bonds? Does it really need to borrow money before it can spend? And do government bonds actually increase the national debt?

In this episode of Understanding Economics, I explain why government bonds are not what most politicians and financial commentators claim them to be.

The UK government issues its own currency through the Bank of England. When it spends, money enters the economy, and when it taxes, money is removed.

When government spending exceeds taxation, the money left in the economy becomes available for households, businesses and financial institutions to save.

Government bonds, also known as gilts, are essentially government-backed savings accounts. They allow investors to exchange money they already hold for a financial asset that pays interest.

This is the crucial point: selling a government bond does not, by itself, create additional government financial liabilities. It exchanges one form of government debt for another.

So why does the government issue bonds?

I explain how bonds provide relatively safe savings opportunities for pension funds, banks and other investors, while also helping influence interest rates throughout the economy.

I also examine the role of the Bank of England, commercial bank reserves and the difference between variable interest rates and the fixed or inflation-linked returns offered by government bonds.

Most importantly, I challenge the assumption that the government must borrow from financial markets to fund its spending.

I argue that government bond issuance is an economic policy choice, not an

unavoidable requirement for financing public expenditure.

The real limits on government spending are the availability of workers, materials and productive resources, alongside the need to manage inflation.

Understanding this changes how we think about government borrowing, the national debt and the supposed power of bond markets.

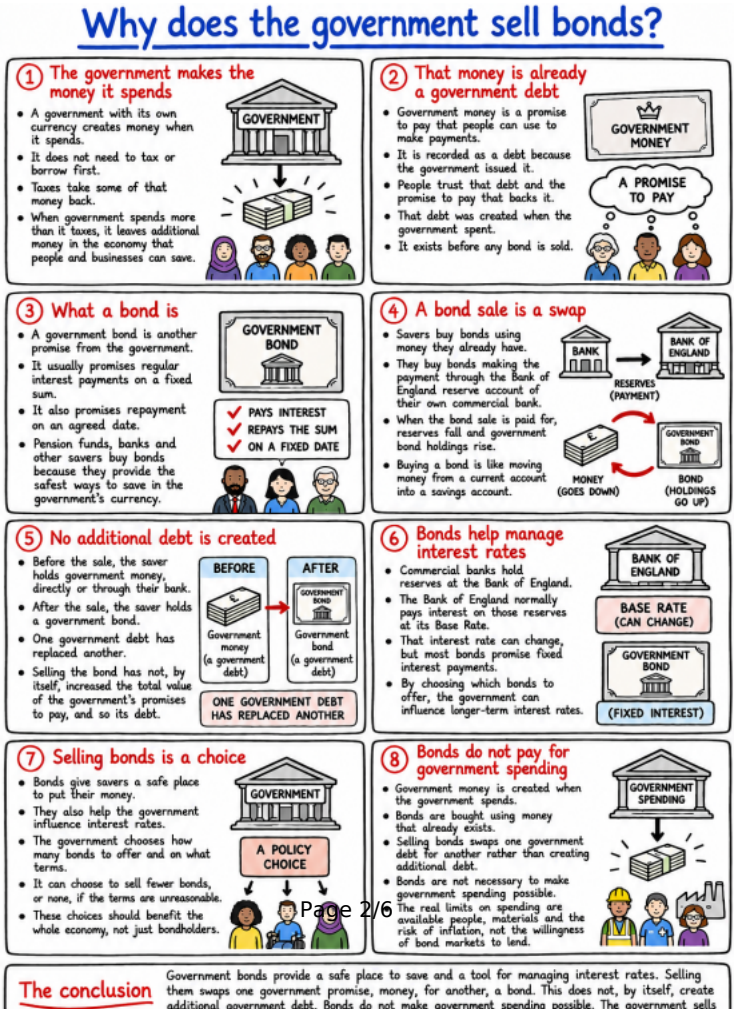
The government should be making economic decisions in the public interest, not simply to satisfy financial markets.

https://www.youtube.com/watch?v=Nd7NmMF4jWw?si=zbEc7gq1w_CpuN7V

This is the audio version:

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This infographic supports this video:



This is the transcript:

Hello, I'm Richard Murphy, and this is Understanding Economics. That's the series of videos that I'm making that explains how I think our economy really works, so that I hope you might do so as well.

And in this video, I want to explain why our government sells bonds. This seems to me one of the most difficult issues that people have with understanding the economy in which we live. They think that bonds are somehow deep and mysterious and beyond their comprehension. Well, let me tell you, they're not. They're easy to understand. And the reason why the government sells them is something I will explain in this video.

Let's start right at the very beginning, though. The government makes the money it spends. You have to understand that point. In an economy like that of the UK, where the government has its own currency, its own central bank, and all its borrowing is in that currency, it can never not pay its debts. And every time that the government tells the Bank of England to make a payment on its behalf, the Bank of England creates the money that the government uses to make that payment.

The government does not have to tax or borrow first to make a payment. It has its own bank. That bank creates money for it. Banks exist to create money. That is their function. They make money every time they lend money. And the Bank of England lends money to the government to let it make its payments. That is how government money gets into circulation in our economy, and you have to understand that, or you cannot understand bonds.

Now taxes take some of that money back out of the economy. That's deliberate. The government has to take most of the money that it creates back out of the economy, or we would have hyperinflation. And so it creates taxes to achieve that goal. That is the primary function of tax in our economy. Tax does not fund government spending. It's there to control inflation.

But when the government spends more than it taxes, and most of the time, and in every year during the course of this century, that has been the case, it leaves additional money in the economy that people and businesses can save. That is how the money that people save comes into existence.

The government is already in debt when people begin to save. Let's be clear about that. Government money is a promise to pay that people can use to make payments. We trust the government's promise, and so we use what evidences that promise, whether it's a balance in our bank account, or a note or a coin, to make payments. And the recipients also trust the government to make their payment. And that's how we end up with a monetary economy.

But that debt is a record that exists in the government's ledgers at the time that we use it. That money exists, therefore, before there is tax and before there is borrowing, and indeed, before there is saving. The government creates it. And that is key.

The debt that the government has is the difference between the total amount that it has spent and the total tax that it has taken back out of the economy. That is the debt, and the debt exists before any government bond is sold. That's the important point.

So what is a bond? A government bond is just another form of government promise to pay. But in this case, it's not like ordinary money. On ordinary money, the £20 note in your pocket, if you so happen to have one, you do not earn interest. But the government issues a bond, and it promises, in addition to the fact that it will repay it at a fixed point of time in the future, to pay interest on it in the meantime.

So this is a fixed-term savings account. That is all it is. You can get one of these from a building society. You can get one of these from a bank, but the government issues more of them than anyone else. But it is just a savings account. Don't complicate the issue. That's what we are talking about.

Pension funds, banks and other savers buy bonds because they provide the safest way to save in the government's currency.

Now, admittedly, you can buy and sell these savings accounts, and you can't do that with a building society account or a bank account, but that's the only difference between the two. There is a market in secondhand government savings accounts, which there isn't for a building society account. But don't let that confuse the issue. It's still just a savings account.

And savers buy bonds with the money that they already have. This is the critical point. If the government had not created money in the first place, and spent it into the economy, and then taken less back out of the economy by way of tax than they had spent, there would be no money to save.

But when people buy bonds, what they do is use the money that is held by them, or more likely by their commercial banks, acting on their behalf with the Bank of England, to buy a bond. Those accounts that the banks hold with the Bank of England are called reserve accounts. And when a bond is purchased, the bank's reserve accounts fall in value, and the value of government bonds rises.

Buying a bond is then like moving money from a current account on which no interest is paid into a savings account on which interest is paid.

Now, it's again slightly more complicated than that in this case. But the important point is that no additional debt is created by this transaction.

When the government issues a bond, and people buy it with money that the

government has already spent into existence, no new debt is created at all. Before the bond was bought, the saver held government money. After the bond has been bought, the saver holds a government bond instead. But one government debt has been replaced by another government debt. There is, however, no more debt in total. The government still has the same total value of promises to pay in existence as it had before the bond was issued. So, this is key to understanding. Government bonds do not increase total government debt.

Let’s just go back to the question of interest rates, though, because this is important. Commercial banks, when they hold money with the Bank of England, are paid interest on those balances at present. I argue that they shouldn’t be, but they are as a matter of fact. And the point about issuing a bond is that the transfer of money out of the reserve accounts into a bond account does something quite distinct.

What it does is remove the variable rate of interest from the reserve account, which the bank is paid and produces a guaranteed rate of interest instead. The bond has a guaranteed interest rate. That might be a fixed rate over its life, or it might be one linked to the rate of inflation. But the point is, in either case, the payment will be made, whereas when there is a balance on a bank reserve account held with the Bank of England, there is no guarantee that interest will be paid. And we saw, between 2010 and 2020, almost no interest was paid on these accounts at all.

So why do people want to buy government bonds? Because they get a positive interest rate and it’s guaranteed to be paid over a fixed period of time, which could be quite long. A bond can exist for up to 50 years. But if they hold their money on a bank reserve account, or their bank does for them, there is no guarantee of an interest rate. So by choosing which bonds to offer and over what periods of time, the government does deliberately influence the interest rates available in the UK economy.

What we have to understand about bonds is bond issues don’t fund anything on the part of the government. They do provide an enormous favour to the financial services sector in this country, who wants to buy them to get a guaranteed rate of interest. But their primary purpose is actually to influence interest rates right across the economy. The government chooses how many bonds to offer, at what interest rate, for what duration to achieve this outcome.

And it can in fact choose to sell no bonds at all if it wants. It can borrow from the Bank of England if it wishes to. There is no legal reason not to. It is just custom dating from the early 1980s that the government always issues bonds to cover its deficits. There is no reason why it should.

Everything about bonds, then, is about choosing an economic policy and not a mechanism to fund government. And it’s choosing an economic policy to influence interest rates for the benefit of the economy as a whole that is what the priority should be, and not just to keep City bondholders happy.

Let’s summarise this. Government money is created when the government spends. Bonds are bought using money that already exists, and when the government sells bonds, one government debt is swapped for another debt, but no new additional debt is created.

So bonds cannot fund government spending because it’s already been funded by the issue of money in the first place. Bonds are not related to the capacity of the government to meet its obligations to us, the people of the country. And the real limits on spending are available people, materials, and the risk of inflation, and not the willingness of bond markets to lend, whatever those bond markets might like to say.

Government bonds provide a safe place to save and a tool for managing interest rates for the government. Selling them swaps one government promise, money, for another, a bond. This does not by itself create additional government debt. Bonds do not make government spending possible. The government sells them because it chooses to, because it wants to help our financial markets, which cannot function without them, but not because it needs to borrow before it can create the money it spends.

Understanding this is essential if you’re going to understand economics, if you’re going to understand why we have bonds, and if you understand why the threat from bond markets is completely hollow, because all the power in this relationship rests with the government and not with the financiers.

That is a key message from this Understanding Economics series. If you want to learn more about the whole series, there is a playlist down below the video. Have a look at it. Please do watch those videos. You will understand economics better if you do, and that is my whole purpose in creating this whole series and, in due course, the book that will follow from it, because one will. That’s my goal. I want you to understand this world better so you are better informed about the risks of living within it.

Poll

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