Can we afford it (redux)

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At some point, we shall emerge from this dark episode in history – one which has claimed over 350,000 lives around the world so far, of which more than 10% are in the UK – as from a long winter. As we step out blinking in the summer sun, we must reflect on what kind of world we want to walk out into.

Last week I touched briefly (read here) on a point that will increasingly impinge upon such lofty sentiments: money. More specifically, the question of how to pay for the emergency measures that have been taken to support businesses and individuals during "lockdown".

I argued that worrying excessively about "how will we pay for it" was erroneous. In spite of the noise to the contrary in some circles, this is actually mainstream economic thinking. There is nothing unorthodox about pointing out that fiscal policy shoulders the burden of adjustment when interest rates are at or near zero.

However, this crisis (and arguably the experience of the decade that preceded it) suggests reasons to go beyond the orthodox. This is arguably what happened after the financial crisis of 2008/9. Quantitative Easing (henceforth QE) was an extraordinary attempt to increase inflation (with the indirect side-effect of supporting economic activity) in the face of insufficiently expansionary fiscal policy.

Although QE was labelled as "printing money" in the press at the time, there are two key distinctions between QE and the conventional understanding of "printing money". In QE the Bank of England buys bonds in the secondary market rather than the primary market. In other words, it doesn't buy gilts directly from the government but instead buys them from existing investors. It isn't financing government borrowing "directly".

Most of us would probably see this as a bit of a distinction without a difference. After all, the entire premise is that the policy drives down market interest rates and it can only do this by increasing overall demand for gilts.

The second distinction is that the Bank of England has said that it will – at some unspecified point in the future – sell the gilts that it now owns and destroy the money it receives for them. This will return the government debt to the private sector so that it will be (close to) the same level as if the Bank had never done QE in the first place.

Of course the financial crisis was 12 years ago now and the process of reversing QE has yet to really begin. Indeed, the latest crisis has precipitated another round of QE. This temporary ownership looks like it might be with us for a while yet!

Yet this has significant consequences for how we think of government debt. The Bank of England is an arm of the state. If the Bank of England owns government debt then that implies that the government owes itself money. Money you owe yourself is not really money you "owe" at all. Interest that the government pays on these gilts is transferred back to the government from the Bank of England.

Compounding this, there are multiple measures of how much debt the government actually has. The strictures within the Maastricht Treaty typically use 'gross debt', which is what is used in international comparisons. Yet that overstates the debt level because the government also has significant liquid assets (i.e. things it could use to pay off part of the debt quickly).

If I have a £100,000 mortgage and £5 grand in savings, I could use that £5 grand to reduce the amount of my mortgage to £95,000. My net debt is therefore only £95,000. This leads to the preferred domestic measure of debt: public sector net debt.

Of course, debt is meaningless without a measure of income. If I owe £20,000 on my credit card, that's a lot of money that will take me a long time to pay off. If Bill Gates owes £20,000 on *his* credit card, he can pay it off tomorrow.

One widely used international measure compares debt to the size of the total economy. In the UK, net debt was around 80% of GDP prior to the Covid-19 outbreak. To give some kind of context, this was about £1.8trn. So how much of this debt does the Bank of England own?

Confusingly, the Bank of England's own liabilities (mostly, but not totally, incurred through the Term Funding Scheme) is included in public sector net debt. The Term Funding Scheme essentially entails loans from the Bank of England to the private sector.

Yet these liabilities are matched by assets: borrowers must repay the loans. Moreover, they are 'secured' against assets, so the Bank of England should not be left out of pocket in the unlikely event of substantial borrower defaults.

In practice, this means that around £100bn of government debt should eventually be repaid by third parties (the government has borrowed money in order to lend it out again). In addition, the Bank of England (via the Asset Purchase Facility) owns around £370bn of gilts.

Between them, these account for around ¼ of all government debt. The Asset Purchase Facility (whereby the Bank of England owns gilts) has existed for well over a decade. The Bank of England now owns a substantial portion of all UK government debt.

Moreover, little remarked by the press is the fact that although government debt increased by £62.1bn in April this year, the Bank of England bought £43.7bn of debt in the same month. Indeed, I would go one step further.

Given that inflation is currently well below its target rate and wage inflation (a key marker of sustained inflation) has been very low for a dozen years, it is clear that even these extraordinary measures are insufficient. Core inflation has remained subdued throughout that time as well.

What is needed is something yet more radical. The preferred option would be for the government to act by dramatically and consistently increasing government borrowing until inflation increases substantially. Given that deficit fetishism clearly abounds within the Treasury and throughout government ranks, this is unlikely.

Directly monetising government debt is therefore the only option. Why do we not do this already? Fear of inflation. Yet the very fact that interest rates are around their lower bound indicates that inflation is too low. A controlled monetisation of government debt could force the hand of those too timid to act.