Gilts and Bonds

An internet search will tell you that Bonds are savings products issued by companies and governments to raise money to fund their investments. For private entities or 'currency-users', this is true. Governments might also be operationally required to sell bonds. This was the case in the days when the £ was pegged to the value of gold and the government had to offer interest-bearing assets as a competitive alternative to exchanging convertible currency at a fixed rate. Failure to do so could have resulted in an outflow of gold reserves or foreign currency.

Time has moved on and we operate in a world of fiat money. Now that the UK has its own free-floating currency which is not converted into gold or physical material, the picture is quite different. The government spends its currency into existence as it credits accounts, creating bank reserves at the same time, and so has no need for revenue from taxation or borrowing before it can spend. Managing reserve balances are operational requirements and not part of funding, although the language and framing used to describe the system by politicians, commentators and many economists remains that of a system long since changed.
This framing has left us with the fears of 'bond vigilantes' holding our government to ransom and the burden of our national debt robbing future generations of their capacity to fund their spending and risk to their prosperity. It has left us with the false notions of government having hypothecated taxes to enable it to 'ring fence' pools of revenue, topped up by borrowing for use at a future date.

How do Bonds work?

If you buy a bond, the issuer promises to pay you a set rate of interest each year and to repay you the amount you originally invested at a set date in the future. Bonds issued by the British Government, called gilts, are guaranteed as the UK Government cannot go bankrupt, and can always meet any financial obligations that are denominated in £s. Quite simply a gilt is a special savings account offered by the Government which earns interest. These are mainly held in large quantities by fund managers. Gilts represent our saved wealth and are the safest financial store of value in the economy. Pension funds make up a large proportion of the gilt holders. We can think of gilts as Government issued money held as savings. Buying a gilt is like moving funds from a current account to a savings account at the central bank (CB) for a specified time. When the gilt matures, the balance is repaid by the CB transferring the amount invested, along with the agreed interest, back into the reserve account of the bank handling the transaction. Because the government is the currency issuer, it does not need to find the money from anywhere to repay these accounts, it simply creates it.

Think of it in terms of your own savings. You have some spare cash, let's say £1000, doing nothing in your current account. You decide to buy a Bond or an ISA and the bank transfers the money from your current account to the Bond or ISA account. When it matures, the bank transfers those funds back into your current account with the agreed interest. In the same way that your bank is not in debt when you transfer your savings from your current account to your savings account and back again on maturity, the same applies to the government. In balance sheet terms it is a swap of government liabilities. Nothing is added nothing is taken away.

So what is the purpose of gilts if not for funding the government?

From the Government's perspective, gilt issuance is done to support interest rate targeting, part of monetary policy, ***not*** for the government to get hold of the money it needs to spend. Under the Gold Standard, it was necessary to dissuade convertible currency holders from conversion at a fixed rate, so that gold reserves weren't exhausted. Much of our government accounting is a hangover from that time. In addition, institutional changes took place over twenty years ago, when the arrangements for debt sales and balancing the government's daily cash management operations were separated from the Bank of England's money market operations and handed to a separate government entity, the Debt Management Office or DMO.

The Bank of England would manage the cash requirements of the government and geared them toward managing the Monetary Policy Committee's decisions on the level of short-term interest rates. If the government's short term cash transactions didn't create a daily shortage in the money markets (in order for the CB to enact monetary policy), then the Bank created a shortage by draining reserves through the sale of Treasury Bills. Managing the government's spending when the government issued debt-free Sterling, was done by a process now referred to as Overt Monetary Financing. This used what was, and still is, known as the government's Ways & Means account at the Bank of England. Gilts were issued by the Bank, as a way of setting the desired interest rate. The Ways & Means account was a balancing account.

Overt Monetary Financing (OMF) is a means for the Treasury to instruct the central bank to spend a particular amount and the central bank makes sure that that money is always available in the government's account. It became a controversial form of government spending. The government would draw on those funds to directly transfer money into the bank account of whoever they need to pay (this could be a firm or private citizen). The payments could be made either by electronically crediting the account or via a cheque, which the payee deposits in their bank. When economists talk about 'printing money' they are talking about the process of the central bank adding numbers to the Treasury's bank account and receiving treasury bonds of the same value in return. This is known as 'debt monetisation'.
Instead of selling gilts to the private sector, the Treasury simply sold the bonds to its central bank, which created new funds in exchange. The central bank doesn't need the bonds, given that it creates the currency 'out of thin air'; swapping the public debt for account credits is just an accounting convention.

The only difference between the Treasury borrowing from the central bank (as in OMF) and issuing gilts to the private sector is the type of accounting operations used to maintain its interest rate target.

Mainstream economists claim that the draining of the reserves reduces the ability of banks to lend. But in the real world, banks create new deposits whenever they lend to credit-worthy customers, they do not use money from anyone else's savings. Banks conduct reserve operations between themselves and the central bank to ensure the payment system operates smoothly. The inflation (see our factsheet at https://gimms.org.uk/fact-sheets/inflation/) risk associated with OMF is no different than it would be for any government spending that was accompanied by private sector bonds sales. This is because any spending can be inflationary.

Directly injecting government 'money' into private sector accounts boosts economic activity in the real economy quickly. This is in contrast to the slower, indirect, effects of monetary operations such as interest rate cuts and QE, which rely on customers and firms responding to the lower costs of borrowing. Nowadays (since 1998), the way the government accounts for its spending and borrowing has changed with the formal separation of debt management from the Bank of England to the Debt Management Office (DMO). The government still spends by crediting accounts, but instead of using its own bank it has 'outsourced' debt sales to the DMO who sell debt to primary bond dealers in the private sector. In addition, the Government uses the services of private banks to handle the collection of its taxes. Where once payments for tax were paid into accounts held at the Bank of England, these are now made to accounts held by commercial banks. To achieve the same results as before, the government has to cover every £ of its spending with gilt issuance and the Bank of England buys back some gilts to maintain its interest rate target. The accounting is identical but the BoE holds Treasury Bills to back the reserve issuance rather than in an overdraft account (Ways and Means).

Why did the government change its accounting structures?

Changes to government accounting structures came about as a result of the desire of the European Community to form the European Union and to create the single European currency (the Euro). The process by which the Euro would become a reality was agreed in the Maastricht Treaty, which was signed in 1992 and the Lisbon Treaty of 2007. Article 104 of the Maastricht Treaty banned the governments of member states from using OMF, and later article 123 of the Lisbon Treaty reiterated the same rule. The Maastricht Treaty also demanded that Central Banks be independent (i.e. they were not to receive instructions from Government on monetary policy) before the creation of the European System of Central Banks) ESCB on 1st January 1999. Independence was granted to the Bank of England in 1997. Other rules in this Euro Convergence strategy (article 121 of the Maastricht Treaty) included having inflation under control, a deficit of 3% of GDP or less and a national debt of less than 60% of GDP (the 'Stability and growth pact; however, some flexibility was to be given in special circumstances).

The Treasury now issues gilts to match all deficit spending under the "Full Funding Rule". This is designed to separate the accounts of monetary and fiscal policy, not because "funding" of government requires it. This was clear in the UK before 1998 when the Bank of England managed debt sales according to the interest rate target and Ways & Means (overdraft) served to balance them. This changed when the redesigning of the institutional structures and accounting made bonds look like they are financing operations. You can examine how the UK government's accounts work by reading the Debt Management Office website at https://www.dmo.gov.uk/about/who-we-are/

OK, if this is not borrowing could the government just stop issuing bonds?

From the point of view of the investor, Bonds and gilts are secure places to hold your money. If you have more than the £85k in savings in a bank or Building Society then the BoE deposit insurance covers it in the event of the institution becoming insolvent. Government secured saving products are the safest financial store of value in the economy. The UK government does not need to issue a bond in order to be able to afford to make payments. It has no relevance to the government's ability to spend or not. All government money is brand new money, created at the point of expenditure. It doesn't matter whether the money the government has is held in a reserve (current) account or a gilt (savings) account. A nation that issues its own currency and floats it on the international currency markets will always be able to repay debt denominated in that currency. Bond markets can never bully such a government by threatening to stop buying bonds. Nations with sovereign currency governments can always issue their own currency without having to borrow.

Whilst the government doesn't need to issue gilts to fund its spending, the central bank uses the issue of bonds to manage its monetary policy (as opposed to fiscal policy). What this means is that the Bank of England sets a target interest rate and tries to defend it, if it is not set at zero. Should the commercial banks find themselves short of reserves in their day to day operations, banks with an excess of reserves will lend it to banks which don't have enough. This is known as the interbank market. As a result of interbank competition, the overnight rate is driven towards zero. If the Central Bank doesn't act, it will lose control of its monetary policy (or, specifically, its ability to maintain a positive overnight rate). To avoid this scenario, it uses bonds to drain off excess reserves to halt the fall to zero and maintain control of its target interest rate. Both the functions of controlling interest rates and offering safe savings products to the private sector could be replaced by simply offering term deposits at the Bank of England to fund managers. There is no need to issue government debt at all if you do this instead.

*Monetary policy involves changing the interest rate and influencing the money supply

*Fiscal policy involves the government varying the levels of government spending and tax rates to influence total (aggregate) demand in the economy.

What is the Deficit?

It is crucial to understand the relationship between the government and non-government sectors of the economy. In the monetary system, there are financial assets and liabilities. For a household, a financial asset could be a bank deposit, cash in your wallet, a government bond or a corporate bond. A financial asset is different from a real asset, such as property, a car or a piece of art, as it has no tangible expression. A bank deposit is a statement of wealth. A financial liability is usually a bank loan or some other debt that is owed. The difference between the total of financial assets and the total of financial liabilities is called net financial assets. This is different to total net wealth or net worth as it does not include real assets.

The financial transactions between different parts of the non-government sector cannot create new net financial assets or destroy previous net financial positions. As a bank creates a loan it creates a new deposit simply by typing numbers into a bank account that the borrower can use as money to spend. The loan is an asset to the bank but an equal liability for the borrower. So there is no net gain in financial assets for the non-government sector as a whole.

The only place that net financial assets or financial wealth can come from is the government. The currency-issuing government, via its own central bank, uses its taxing and spending powers to create and destroy (spend and tax) net financial assets into and out of the non-government sector. These transactions happen on a daily basis. If the government needs to spend more money than it collects in taxes, it establishes a deficit, which is an increase in the net financial assets in the non-government sector. Taxes destroy currency, reducing the amount of money in the private sector. The fiscal deficit increases wealth, whereas a fiscal surplus reduces the financial wealth of the non-government sector. Put simply, Government spending creates money, taxes destroy money and gilt issuance (or term deposits at the BoE), just converts money from current accounts to savings accounts.

The size of the government's deficit is dependent on net exports (leakages from the domestic economy) and the desire of people to save in a given period. The government cannot target the size of its deficit in advance, it is endogenous; its size depends upon these non-government sector factors which are outside of its control. Those with savings in sterling they need a safe place to store their money, so they buy gilts. So the demand for gilts always matches the government's deficit (unless, as happens very rarely, primary bond dealers' demand for gilts is less than supply), which is a response to saving desires and not a funding requirement for the national government. The swaps of reserve balances, from one type of savings account to another type of account are the operational requirements of managing reserves held within the banking system. The privatisation of UK government retail banking deposits, which happened just a few years ago, doesn't change any of this. The government's wholesale banking is still at the Bank of England, with private banks used for retail payments services by the government, for administrative reasons. The existence of this system changes nothing of substance about government finances.

The Gower Initiative for Modern Money Studies

More information:

Stephanie Kelton: The National Debt is actually a government savings account - https://youtu.be/9BYhoMILwR4

L Randall Wray: Why do governments that issue their own currency bother to sell bonds? - https://www.youtube.com/watch?v=pex89N9Oqog

UK Debt Management Office: Exchequer cash management in the United Kingdom. Cash Management Operational Notice & Treasury Bill Information Memorandum 1 September

Fiscal Policy in a Stock-Flow Consistent (SFC) Model - Wynne Godley and Marc Lavoie (2007)

Money creation in the modern economy - Bank of England Quarterly Bulletin 2014 Q1