There is no money

Dieter Helm

18th May 2020

As the full impacts of the lockdowns become painfully obvious, there is much talk of new stimuli and in particular green recovery plans. The idea is that we can get back to the pre-virus aggregate demand by borrowing and spending and doing this by spending in particular more on green projects. By conflating the two, the extra spending on green projects gets funded by debt, backed by Quantitative Easing (QE), and hence there are no hard choices to make about paying it. It is classic "cake-ism": more green investment and more spending and more income too. In this unconstrained world, the lockdowns will not therefore have done anything other than temporarily dented our standard of living and environmental aspirations. Better still, the advocates of the green recovery plans funded by QE financed debt argue that the projects are all shovel ready, so they increase demand and economic activity immediately.

It sounds too good to be true, and it is. The case for some of the green investments is a strong and stand-alone one, but the case for using more debt and more QE to make it happen is not, and the shovel ready argument is weak: there are lots of quicker labour-intensive shovel ready projects, like housebuilding and roads. By opportunistically linking green recovery with macroeconomic Keynesian demand stimuli, the green case may well be weakened, not strengthened. In a world with major constraints on borrowing, the case for green investments may in fact need to be made in a much more challenging and adverse context. This short paper focusses on the macroeconomic argument, and the post lockdown world where hard economic choices will have to be made, and where the trade-offs between spending and how to pay for it remain. There is no magic money tree.

"This time is different"

The last time there was a major global shock, the financial crisis in 2007/08, there were similar calls for large scale borrowing and spending. As the deficits rolled on in the post-crash decade, and debt increased, attempts at imposing financial discipline were dismissed by Keynesians as "austerity". Their critique was not that governments were borrowing too much, but rather they should have borrowed even more.

Reality turned out rather differently. When the Coalition of Conservatives and Liberal Democrats came to power in 2010, the new Chief Secretary to the Treasury found a note left in the Treasury by the outgoing Chief Secretary, Liam Byrne simply saying "I'm afraid there is no money" and wishing his successor "good luck". The last time Britain went bust was in 1976, when there was a sterling crisis, a sovereign debt crisis, a balance of payments crisis and an inflation crisis, the then Chancellor, Denis Healey, had to ask the IMF for an emergency loan and sign a "letter of intent", which included expenditure cuts and a return to fiscal discipline. James Callaghan, taking over from Harold Wilson, told the Labour Party in 1976 that:

> *We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that this option no longer exists, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step. Higher inflation followed by higher unemployment. We have just escaped from the highest rate of inflation this country has known; we have not yet escaped from the consequences: high unemployment.*

An obvious question to ask is: Why should it be any different this time around, compared to 1976 and 2007/08? Where does the money come from? Who borrows from whom? Who is going to repay the debt? The answers then were as stark as they are now. The assumption that all the developed economies can turn to the debt markets to simultaneously finance enormous increases in borrowing was then and is now implausible. The difference is that almost all governments and some economists do indeed think that it is different this time, that the debt does not much matter, and central banks can mop up the extra debt through QE. The implication, they claim, is clear: in 1976 and in 2008/09, QE should have been used, and on a much greater scale.

The reason QE is reached for is that, contrary to the "savings glut" hypothesis, there is not a wall of private investors who are willing to lend to governments at zero nominal and negative real interest rates. If there were, there would be no need for QE. The Bank of England (BoE) found this out back in 2008, and it found it out too in March 2020. It struggled to raise £3.25 billion on 19th March 2020, and it just made it before the gilt market froze. The BoE responded by cutting interest rates to 0.1% and launched a £200 billion QE programme. The Office for Budget Responsibility (OBR) initially said that the lockdown will cost £230 billion (£100 billion of policy support, and £130 billion for the recession). Add in the roll-over of existing old debt, and the Debt Management Office (DMO) would need to raise £380 billion in 2020 compared with £228 billion in 2009-10. Sir Robert Stheeman, chief executive of the DMO, told *The Times* that as a result of the £200 billion QE "the market has settled down… It has got used to the idea that there is one large seller in the primary market – us – and in the secondary market there is one large source of demand – the Bank…. Without the Bank buying, yields would likely have been massively higher than now" (*The Times* 30th April 2020). The BoE makes the argument that because it is operating in the secondary market, its activities are about stability and not monetarisation. What it fails to explain is the obvious intimate link between the primary and secondary markets.

What is going on here?

The details of exactly how QE works is a matter of considerable dispute amongst economists. This is for two reasons: first, that the counterfactual (what would have happened otherwise) is a hypothesis and not an empirical proposition; and second, that most economists see the problem now and back then as a demand deficiency one – that spending is too low to maintain full employment and underpin economic growth. Both bear examination, but to start it is important to be clear about the processes of QE. What happens?

If the government chooses to increase spending on unemployment and welfare benefits caused by the lockdown and the recession it has caused, and to increase spending on health and social care, it has several options to pay for all this. The first is to raise taxes, using its ultimate power to extract money from its citizens. The lockdown has made us all worse off, and we can pay for the damage by paying more taxes and lowering our standard of living accordingly to reflect our straightened circumstances.

The second option is borrowing, to fund the extra spending. If the lockdown and the subsequent recession are expected to be *temporary*, it is argued that the borrowing tides over the government, and in due course it may be able to pay the borrowing back and the deficit will return to its *status quo ex ante*. The stock of debt will remain greater than it otherwise would have been, but on this view, it can be paid back over the business cycle in the medium term. We are still worse off, but there is no need to lower our standard of living by much immediately. It is ultimately just a nasty version of a business cycle, and the job of government is to tide us all over, using the savings from the boom years, stabilising incomes over time, and spreading any pain into the medium and long runs.

There are two obvious problems with this. The first is with the assumption that the shock is temporary, rather than an exacerbation of a downturn that was already underway, and that the level of borrowing was, prior to the shock, sustainable. Suppose that the level of consumption prior to the shock was higher than the sustainable level and suppose that before the lockdown shock governments were already raising deficits through extra spending, already funded not by higher taxes but by borrowing. We would have been already living beyond our sustainable means, *before* the shock. It is just assumed by the borrowing advocates that the *status quo ex ante* was perfectly sustainable in the absence of the lockdowns. But on the contrary, by January 2020, there were strong arguments that an asset market bubble was about to burst, and that recession was already coming.

The second problem is that the people who are supposed to pay back the debt are not the same as those benefiting. In both the 2008 case and now, these are the young and future taxpayers. What if they are not willing or able to do so? What if "austerity" in the future is not politically possible?

Why the Bank of England thinks this is not monetarisation of the debt

This is where things get difficult. Historically a number of countries have come to this point: raising money that they, for a variety of economic and political reasons, find themselves unable to pay back. They always end up defaulting: the variance is in how they default. Broadly there are two options: outright default, as with Russia in 1998; or through inflation writing down the debt (as in the UK in the 1970s, with two years of 25% inflation, followed by three years of 10% inflation).

The BoE is so worried by the possibility that markets may believe the second (inflation) is going to happen now (it ignores the first), that its Governor wrote an article in the *Financial Times* (6th April 2020) *Bank of England is not doing 'monetary financing'*, inadvertently giving credibility to this very possibility. His argument is simple: the BoE has independence and can always raise interest rates if inflation starts to pick up. This is true as far as it goes, but the idea that debt and inflation is solely a technical and legal issue assumes that the politics go away, or at least politics bows to the BoE technocrats.

A little speculation about the circumstances that might arise would suggest caution. Imagine the following scenario. First the government borrows to stimulate growth, assuming that economic recovery will result and hence provide the extra national income to pay back the debt. Now suppose the growth does not materialise. Suppose the consumption level was already unsustainable, and as with the stimulus post 2008, the policies do not work. Now what does the government do? It could raise taxes and cut expenditure, thereby tipping an already weak economy (by assumption in this scenario) into a recession or even a depression.

Suppose it faces an election, as it always will. This is not a war situation of national unity, but a classic political fight. Might it not now ask the BoE to print more money to borrow more and even to pay the interest? No doubt, as now, the Keynesians would say that this is a great idea, because their diagnosis is that economic problem is lack of demand, and pump priming the circular flows of income will do the trick. If the initial stimulus did not do the trick, then the answer is to try harder and do more. By continuing with QE, the inflation the Governor is worried about from monetarising the debt (which is what would now be going on) might get going.

But writes the Governor, don't worry: we will stop inflation dead by raising interest rates to whatever level necessary (as for example Mrs Thatcher did in 1980). There are two political replies: why not just get rid of the independence; and anyway, the inflation target could be raised and the mandate itself widened to include say GDP growth. Independence of the BoE is relatively new – for most of its several hundred years history, it has been controlled by the Treasury as a nationalised business. In the end the decision will be political, and it is not clear that politicians will want to take the drastic path Thatcher took.

Perhaps the Governor's fears about inflation may be misplaced. Monetarisation does not necessarily cause inflation. It could cause deflation (if the velocity of circulation or the number of transactions fell more than the increase in the money supply). In this scenario, the private sector sees what is happening and holds back on investment. Low growth leads to higher unemployment, which depresses wage growth, and the workers are further cowed by the coming of more and more robotics, 3D printing and AI, all encouraging a switch from labour to capital. These new digital technologies do not go on strike, do not sleep, do not get coronavirus and do not need to be socially distanced. It may be in future that it is not the workers who cause inflation, but rather the cost of capital equipment. That appears to be on a strongly downwards trajectory, and if robots are built by robots, there is little to stop this cost reduction trend. Deflation may make negative interest rates quite normal. Hence government can go on monetarising the debt for a very long time.

Where does all this end?

Suppose that the above deflationary scenario plays out. Supposing, as with the 12 years since the 2007/08 financial crash, QE does not revive economic growth (itself flattered by a rising population in this period). How long can this monetarisation go on, before governments have to face the music of bond markets?

There are at least two possible end points. The first is that the broader markets run out of faith in government. The bond market might not react, because it is not being tapped, as it is being replaced by QE. But the exchange rate might take a battering. For a large, primarily internal and closed economy like the US, this might be possible to weather. A sharp fall in the dollar would advantage US exporters, be bad news for China, and the inflationary consequences may be contained because most economic activity is within and between the US states. The EU as a whole could take a fall in the Euro (though if the dollar is falling too, we might have competitive devaluation, with China joining in the game too).

Sterling is in a very different boat. After BREXIT, and with bare-bones trade deals at best in the offing, a small open economy, dependent on trade, the UK is in a very different place. The UK imports 40% of its food, its manufacturing sector is only 20% of the economy, it is heavily dependent on global supply chains, and it depends heavily on the financial markets in London to yield a capital account surplus to offset the current account trade deficits. BREXIT and more autarkic approaches in the US, the EU and China make London much more vulnerable to displacement by New York and Frankfurt/Berlin and Paris. Recall the great growth of financial services came on the back of US banks moving to London to be inside the EU. Why bother now? Why not either go back to New York, since there are few benefits of being in London outside both the EU and the Euro? Or, why not choose Dublin (for the language), or Paris and Frankfurt/Berlin? Or eventually Edinburgh in a possible independent Scotland?

It is a fair bet that the point of a borrowing/QE crisis in the UK will come earlier than for most others, and that sterling would come under pressure, raising import prices. The historical response to a sterling crisis has been to slam on the brakes – raise interest rates, increase taxes and cut expenditure – what might be called proper austerity. This time around, the great import cost reductions which came from globalisation and China may at the same time be unwinding, and especially if there is a deglobalisation of supply chains going on in the background. Producing stuff at home rather than importing it is almost certainly going to raise costs. Many prices, quite a lot of public spending, utility bills and interest payments are inflation indexed. If and when inflation gets going, it will be hard to stop. It almost always is.

The second end point is to go back to the pre-1979 economic planning approach. Governments could impose exchange controls (as does China) to protect the pound, require banks to hold Treasury bonds at low rates as part of a financial repression (a form of taxation), and sharply raise taxes so the state can direct the “surplus” from consumers into investment. This may seem to many ancient history, but it is not. It was what happened in the post Second World War period up until 1979, and it was how the repeated economic crises from 1963 through to the devaluation in 1967, through to the inflation crises of the mid and late 1970s, were dealt with. Exchange controls were the key necessary condition for these policies.

It is also not ancient history because it is pretty close to what the Corbynite faction in the Labour Party proposed in its manifesto in 2019. The exchange controls and the financial repression via the banks may have been formally missing, but it is not difficult to see how this siege path might have been taken. As with the Mitterrand "socialism in one country" experiment following his election victory in 1981, it may not have lasted long (in France's case it collapsed in 1983), although with BREXIT and without any need to align exchange rates as Mitterrand had to in the early 1980s in Europe, it would at least be theoretically possible to move to a more siege economy. It is what Mitterrand himself referred to as the "Leninist" approach.

What to do now

Let's now consider the merits or otherwise of the demands that the UK government launches a major fiscal stimulus in the autumn 2020, financed by QE. Assume that this is added to the £200 billion the BoE has already printed. Say £450 billion QE by the end of the 2020. Add this to the £375 billion from last time around. Say around 40% GDP. This is of course not the national debt. It is just that component of the national debt financed by QE. National debt may be significantly more than 100% GDP – perhaps 120%, or more if GDP contracts.

That last number (120%) is not in itself is not a particularly scary. It was exceeded for quite a lot of the period from 1945-1970. Yet in that period it was a very large but *falling* number. The question is whether now it is a very large and *rising* number. That in turn depends upon economic growth: the period 1945-70 was a golden age of economic growth, better than anything before or since in UK history and the debt could be comfortably covered by rising income, though it took the big inflation of the 1970s to write most of it off – defaulting implicitly. Remember too this was all managed under exchange controls.

That growth is unlikely to be the case now – unless the borrowing backs investments with high net present values (as the green recovery advocates claim). Although there is plenty of scope for a sharp bounce back from the lockdowns, the growth outlook for the UK and globally too is a depressing one. It already was in January 2020 before the lockdowns. China's great economic motor of world economic expansion was already spluttering before the coronavirus came along, productivity is widely poor despite all the new technologies. There is little evidence, despite what all the lobbyists and activists say, that the UK is growing world class renewables energy companies that will produce lots of export earnings. Indeed, in the North Sea, the offshore wind industry is to a significant degree "Made in China" and constructed largely by the European companies. There are virtually no UK world leading large renewables companies, despite all the subsidies. Renewables may be highly desirable to meet the UK's unilaterally carbon targets, but they are not so far, the engine of economic export growth.

This leads to a central challenge to those who advocate another debt-driven investment stimulus: how exactly is the investment going to produce export earnings for a smaller open economy like the UK? If it is the case that there are lots of high return investments in the UK, and these opportunities are better here than in competing countries elsewhere, then the investment case is clear. But where is the evidence? And, more revealing, why do the advocates want governments to raise the money to pay for these apparently high return investments, when if they are so good the private sector should be jumping at the chances?

Rather what the advocates of a new stimulus want is something rather different. They want investments to address the degrading of our natural environment, the reduction of UK territorial carbon emissions, more health and more social care and greater infrastructures. The key point is that these are to maintain and enhance our standards of living, and to deal with the pollution we are causing and the neglect of our public services.

Many of these are very desirable from a well-being perspective and to fulfil our obligations to future generations. But the state of all of them reflects the fact that we have been living beyond our means, not paying for capital maintenance of our natural, physical and social capital. It reflects the fact that the level of consumption was unsustainably higher before the lockdowns. Trying to maintain or even increase consumption now will compound the difficulties of addressing these pressing environmental problems. Hence the paradox: a green recovery plan might turn out to be very un-green. This is especially relevant when considering one thing the lockdowns have revealed: emissions are correlated with GDP, not decoupled. As China has economically recovered, so too have its emissions, just as they fell in China and across the developed world when the lockdowns reduced GDP.

The key task now is to head off a recession (or depression) and go green. If consumption is unsustainably high, then the route to full employment is via investment, and investment which is consistent with sustainability. How can we get back to sustainable (lower) consumption, whilst raising investment, and achieve a return to full employment?

The answer lies with savings, and the translation of savings into investment. These savings should be from us now, not from future generations. In *How to Pay for the War*, Keynes indicated that this could be achieved through higher taxation, since only in this way could the state direct the surplus it extracted from reduced consumption into production and investment. Consumer demand was to be crushed.

Those who want more spending and no tax increases might argue that it is low tax that leads to investment and hence greater economic output, that the private sector will rise to the challenge. It might seem that way at present, with zero nominal interest rates, and negative real interest rates, companies would have spent the last 20 years investing. But this is not what has happened. Instead they have been engaged in financial engineering, gearing up balance sheets, doing share buy backs and pumping out dividends. Investment is not what has happened with negative real interest rates. Savings have not materialised either because there is no incentive to save. If interest rates returned to normal (say 2% above inflation), then the market should be able to fulfil this function. But ultra-low interest rates, underpinned by QE and the monetarisation of debt, have blunted the normal operations of the market.

It remains to address wages. These are typically regarded as “sticky”. John Hicks suggested that after the Second World War, the economy moved onto the labour standard (as opposed to the gold standard). Some propose to increase wages now to increase aggregate demand. This will not work, except in the very short run. It will accelerate the shift from labour to capital, workers to robots. The solution to this problem of low wages is redistribution, separate from the cost of labour, possibly by some sort of basic income.

Conclusion

Another round of stimuli, fiscal and monetary, is not going to work except in the very short run and it is not the way to drive the greening of the economy. “Green” is not just a supply side problem, to be fixed by technology, though this plays its very important part. Rather what is required is to reset the economy within the bounds of sustainable consumption. There are a host of no regrets policies, and indeed almost everything set out in my *Green and Prosperous Land* is economically efficient, once polluters pay, public goods are provided and there is net environmental gain when damage occurs.

It is not the Magic Money Tree, but rather hard choices that will lead to a greener recovery, backed up by a switch from consumption to investment. The lockdown has made us worse off, and we will not resolve the challenges now by pretending otherwise. There is, as Liam Byrne pointed out, “no more money”. We have to live sustainably and within our means. That is what “green” really means.