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Federal Debt and Modern Money

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If you want to criticise something, it is best to make sure you understand it first. This applies, even if yours ranks as one of the most eminent names in the economic establishment.

A series of recent attacks on modern monetary theory (MMT) have been launched without the authors of these attempted critiques having taken the time to read the MMT literature carefully enough to gain a correct understanding of that which they seek to attack. This has been most unfortunate. By constructing a series of straw men and then demolishing them, these people have failed to engage with the important insights offered by modern monetary theory and the potential policy innovations that they suggest. One of these insights relates to the role played by government debt securities in a modern monetary system, when these securities are denominated in the currency the government issues, and when that currency is on a floating exchange rate regime.

Imagine you do some work for a sovereign currency issuing government such as the US government (perhaps you are building a wall). The government will pay you in their currency - in this case US dollars. These dollars represent a financial liability of the government, and are a financial asset to you, which you can then use to extinguish your (future) tax liabilities.

The government could have equally as well chosen to pay you in US government bonds, which are also a financial liability of the government and a financial asset to you. There is no profound conceptual difference between currency and government bonds.

So why do monetary sovereign governments need to issue bonds when doing so merely swaps one government financial liability for another? The short answer is they don't.

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However, the reality is they choose to issue them, and so it is worthwhile exploring one implausible explanation and three plausible explanations as to why they do so:

1) To raise the currency the currency issuer uses to pay for its spending.

2) To drain excess reserves from the banking system, to prevent those reserves from putting downward pressure on the official interest rate. (In countries where central banks have deliberately created excess reserves, due to past or present quantitative easing, this motivation no longer exists.)

3) To offer fund managers nominally safe interest-bearing financial assets. (Government bonds are best thought of as transferable savings accounts at the central bank).

4) Because it is a habit we have got ourselves into. One of those practices which might have been a good idea once, but which there is not much reason to persist with now.

A rudimentary understanding of MMT reveals that the first of these is clearly not a possible explanation. The second and third reasons are plausible, but not compelling. It is the last of them which we are going to argue is correct.

Why bonds are not issued to 'pay' for spending (Reason 1)

Although it remains dominant, and is in places apparently almost unchallenged, it has been clear for many years that neoclassical economics fits perfectly Imre Lakatos' description of a degenerative research program. Its predictive failures have regularly been swept under the carpet, or catered for by a series of ad hoc and often absurd auxiliary assumptions, to defend its core axioms from attack.

This has had damaging and sometimes disastrous effects on the range of policy options a supposedly credible political candidate is able to discuss. It has biased economic policy making towards a neoliberal agenda. A famous quote from Hyman Minsky comes to mind – 'The game of policy making is rigged. The Prince is constrained by the theory of his intellectuals.'

The core neoclassical general equilibrium model is a model of perfect barter. It has no need for realistic monetary institutions. Indeed, there is no room for real-world money and financial institutions within the model. Attempts to introduce money and finance into neoclassical models are bound to fail. It is impossible to have a sophisticated understanding of the financial system, if you use a neoclassical frame to guide your analysis. And as Warren Mosler has said, 'lack of understanding of the monetary system has been the worst enemy of the progressive agenda'.

William Mitchell and Louisa Connors have explained the ways in which neoclassicism is buttressed and protected from attack by the pervasive use of misleading metaphors, relating to the monetary system and the position of a monetary sovereign government within its monetary system. The 'government as household' metaphor is the most egregious of these. It reinforces and is reinforced by the web of myths and misconceptions at the heart of neoclassical macroeconomics. A failure to understand the distinction between a currency issuer and currency users undermines everything else, and necessarily generates biased and inefficient policy decisions and outcomes.

A lack of understanding of the crucial distinction between the net financial liabilities of a monetary sovereign government and the net debts of households, businesses or non-monetary sovereign governments, has led to disastrous outcomes. Most notably of late, this has applied to the Eurozone. But it biases policy debates everywhere. It feeds into balanced budget proposals in the USA and elsewhere, the European Fiscal Compact, and pointless and counter-productive discussions in monetary sovereign governments the world over of how to 'return to surplus', 'pay down the debt' or avoid passing on government debt to future generations. These discussions take place as though government debt can be identified with private debt, where households are responsible for repayment. They ignore the fact that households are recipients of interest payments on their savings.

The general view of the purpose of issuing monetary sovereign government debt securities (government bonds, notes and bills) and of their role in the monetary system is demonstrably incorrect. The use of the words 'bond' or 'debt' makes us think of these government liabilities as equivalent to corporate bonds, or to household debts. As everyone knows, when households spend, they must do so out of new income, by running down assets they have accumulated in the past, or by taking on additional debts. These debts have to be repaid with interest in the future, which means that unless the household enjoys sufficient capital gains on their assets to fund the repayments, they will need to spend less in the future or earn more. Taking on too much debt leaves you with a vulnerable balance sheet, so that you might be forced into bankruptcy.

Large corporations sell corporate bonds to fund managers, with the assistance of investment bankers. The rate of interest they have to pay on these corporate bonds depends on the general level of interest rates, but also on the credit rating of the issuing corporation, and on the prevailing degree of risk aversion on the bond market. Credit ratings matter, if you are a corporation, or for that matter if you are a non-monetary sovereign government issuing bonds, including foreign currency denominated sovereign bonds. There is always the risk of a downgrade from Standard and Poor's or the other ratings firms, which raises the interest rate you have to pay on your debt. You are more vulnerable if you have what is seen as an unusually high debt to equity ratio in the first place in your industry. Leverage can boost the return on equity you can offer to shareholders, but it exposes you to financial risk. In bad times, it can be difficult or impossible to roll-over debts as they fall due, and insolvency and liquidation are possible outcomes.

The likelihood that good economic times will lead to the build-up of ultimately dangerous levels of leverage in the private sector, transforming balance sheets from safe hedge balance sheets to less safe speculative or even Ponzi ones, was discussed by Minsky. This is the process by which stable and secure financial systems become fragile ones, in his financial instability hypothesis.

So everything people conventionally believe about borrowing and debt is absolutely true, where the private sector is concerned. It is even true where non-monetary sovereign governments are concerned. But is isn't true about monetary sovereigns. It isn't true about the US federal government, or the British central government, or the Australian commonwealth government, to give three examples. It isn't true of any currency-issuing government which issues liabilities denominated in that currency, assuming no gold standard or fixed exchange rate.

When currency-issuing governments spend, they create currency. When they tax they destroy currency. The currency they create is the asset the private sector needs to pay its taxes and other obligations to the currency issuer. Those obligations are defined in units of that currency. As Stephanie Kelton and other modern monetary theorists regularly point out, to introduce a new currency, a currency issuer needs to spend it into circulation before using taxation to remove some of what has been spent from circulation once again. The taxation creates a demand for the currency, because the currency is essential for the payment of taxes. It also limits the ability of the non-government sector to purchase goods and services with the currency, creating room for the government to spend, without going beyond the productive capacity of the economy. As Randall Wray says, taxes drive money. As William Mitchell has pointed out, the term revenue, used in the context of taxation, literally refers to the return to the government of something the government has previously spent into existence.

So governments spend, and then they tax. The gap between the spending and the taxation, which makes up the fiscal deficit, provides financial assets for the rest of us to save. The government's deficit is the non-government sector's surplus. Governments which run deficits most of the time will accumulate a net debt, which is often referred to misleadingly as the national debt. This is the scary figure so often represented on debt clocks, and treated as a burden, or perhaps a threat, or a sign of national malaise, by those deluded by the government-as-household or government-as-business metaphors, confused by a neoclassical frame, and mystified about how monetary systems actually function.

It is nearly always the case that governments issue bonds to approximately offset the gap between their spending and their revenues. Stephanie Kelton uses the STAB acronym. First comes the spending, then the taxation, and then the borrowing. But in what sense is it borrowing? Currency is a financial liability of the government, broadly defined to include its central bank. Looked at this way, the debt issuance by the government, if you insist on using the term debt at all, takes place at the moment the government spends, and this happens every day, all the time. Every dollar the government spends is a new dollar. But every new dollar the government spends is a new financial liability – albeit one which can only be converted into other units of itself, or used to discharge tax or other obligations the private sector has to the government. So what is the government doing when it auctions bonds to private financial institutions? This cannot be a financing transaction, as the money that will be used to purchase the bonds has already been spent into circulation by the government, which is issuing the bonds. The bonds are a government liability, but so was the currency. In the case of currency held in electronic form, such as the reserve deposits of private banks at the central bank, currency even bears interest. The issuance of bonds involves the exchange of one interest-bearing government liability for another. When monetary sovereign governments issue bonds denominated in their own currencies, they are not borrowing, in the conventional sense, at all. There must be something else going on.

Bonds issued to help control interest rates (Reason 2)

When we seek a purpose for the issuance of government bonds, based on a correct understanding of the monetary system, we usually identify a potential role in interest rate management. When central banks select the rate of interest on overnight, or very short term, inter-bank loans, as their official interest rate target, they accept the task of maintaining the supply of reserve balances to private banks equal to those reserves the banks need to hold, to meet minimum regulatory requirements, or desire to hold at that interest rate, where no statutory minimum requirements exist. A variety of factors cause the demand for reserve balances to vary from day to day, the most significant of which are transactions between the federal government and the private banks. The

central bank ensures that the supply of balances varies endogenously to match changes in demand by trading on the money market, using repo transactions in, and also outright purchases or sales of, government and other securities to fine tune the supply of electronic cash to the banking system, and hit the interest rate target.

Fiscal deficits increase the supply of reserve balances to the banking system. They would flood the banking system with excess reserves, if no offsetting measures were taken, and cause the central bank to lose control of its chosen interest rate, so that the rate would fall towards zero, in the absence of interest payments on private bank reserves at the central bank, or towards a floor set by the interest rate paid on reserves, when such payments are made. In order to stop this from happening, the Treasury or central bank needs to issue debt securities, the sale of which will remove the excess reserves from the system. This was explicitly stated as the reason for a transition from the tap issuance of government securities to their issue by auction, by the Reserve Bank of Australia, in 1982. In the absence of central bank securities, it is the Treasury which must issue government bonds for this purpose. So goes the tale.

This is not a strong justification for government bond issuance. In the first case, an understanding of macroeconomics informed by stock-flow consistent modern monetary theory leads us to conclude that the impact on aggregate demand of changes in interest rates is uncertain, often weak, and potentially even perverse, in that lower interest rates in the long run are liable to be deflationary, due to their implications for net interest payments from the government to the private sector. A strong case can be made for a zero-interest rate policy, on this basis, with the supply and direction of private credit being an issue for regulation, and interest rates charged to borrowers a reflection of lending risk and the impact of regulation, and not central bank monetary policy.

In the second case, leaving the additional reserves created by government net spending in the system does not, as explained above, require a zero-interest rate policy, when the central bank pays interest on reserves. The official interest rate becomes the rate the central bank pays on reserves, rather than it being a target for the rate on inter-bank loans. This should be obvious by now, as it is the consequence of current or recent quantitative easing, which where it has involved the acquisition of government bonds on the secondary market by central banks, has generated the same balance sheet positions as would have applied if those government bonds had never been offered for sale to private investors in the primary market in the first place. The issuance of government securities by the government of Japan at the same time that the Bank of Japan is purchasing large amounts of government bonds in the secondary market is nothing short of ridiculous. Under these circumstances, bond issuance is clearly pointless, inefficient and absurd. The central bank may just as well provide the government with a notional overdraft, limited only by the normal budgeting

processes which operate in any democracy. Spending and taxation decisions are taken by elected politicians, and then enacted by the central bank. No government bonds are necessary. If a decision is taken to retain a non-zero interest rate, set by the central bank, then this rate can continue to be the rate paid by the central bank on bank reserves, as it is now in Japan, the UK and other countries to have used quantitative easing in recent years. Economists at the bank for International Settlements (BIS) explained soon after the Global Financial Crisis that quantitative easing had 'decoupled' the supply of reserves from the official interest rate. They may as well have said that quantitative easing had made plain that it is unnecessary to issue government debt securities at all to manage official interest rates.

Bonds issued to offer fund managers nominally safe interest-bearing financial assets (Reason 3)

Other potential purposes for government bond issuance are to offer private savers a nominally safe, interest bearing financial asset to hold in their portfolios, and to provide benchmark risk-free rates of return with reference to which yields on risky securities, such as corporate bonds, can be set. Once again, the argument is not compelling. Assuming that you do not wish to hold risk-free rates at zero across the yield curve, the same purpose can be met by the central bank offering private investors interest bearing term deposits of various maturities. These would naturally be seen as monetary assets, and part of a broadly defined monetary base, and would not naturally be viewed as debt in the conventional sense. It would be obvious to all that there could never be any default risk relating to them.

We could replace government bonds, which are effectively transferable savings accounts at the central bank, with actual term deposits at the central bank. By doing so, we would eliminate the dread people feel about the so-called national debt, which is not the debt of the nation at all but merely the net financial liabilities of the federal government. In place of discussions of whether the national debt is too high, we could discuss whether we are adding enough to a newly defined 'broad monetary base', or more simply to the net money supply.

It would be obvious that government spending always involves the creation of money, and that this money is not a debt, in the conventional sense of the term. This is true of government bonds and other government 'debt' securities already, but this fact is not understood by the public, the media, politicians, or even by many neoclassical economists. We could and should simplify the system, so that the realities of our monetary system, and the appropriate role for the government budget and the government's balance sheet within that system, are made clearer to all. Such a reform would shift the narrative, where macroeconomic policy is concerned, and have a positive

impact on policy making at a moment in history when we can ill afford to labour under misapprehensions and delusions about the constraints facing policy makers.

Government bonds as an anachronism (Reason 4)

The issuance of government bonds is an institutional feature of our monetary system that most people take for granted, as a fact of life. Institutions can be purposeful, but can also be anachronistic. The issuance of bonds by non-monetary sovereign governments is purposeful. When countries were on a gold standard, and currency issuance was supposed to be limited to the value of gold reserves at a fixed official price, then the issuance of bonds had a purpose. It withdrew currency from circulation which might otherwise be converted by the private sector into gold. It allowed for additional government net spending to take place, without increasing the ratio of currency to gold reserves. A similar logic applies when a currency board system of fixed exchange rates is in place, where reserves of US dollars are supposed to limit domestic currency issuance. And, of course, governments and central banks wishing to maintain an overvalued fixed exchange rate and who lack foreign currency reserves, need to issue foreign currency denominated in sovereign bonds for that purpose. As do governments which have ceded their monetary independence in the euro-zone, which as a result are effectively always spending and borrowing in a foreign currency, or at least one over which they have no sovereign rights.

But none of the above applies to the USA, Canada, the UK, Japan, Australia, New Zealand, and a list of other countries. These countries have governments with their own floating currencies, and no significant foreign-currency denominated debt. While they have every reason for deficit spending, to meet the net saving desires of the private and foreign sectors of their economy and maintain the economy at non-inflationary full employment, they have no essential reason for the issuance of debt securities. The issuance of these bonds reinforces the neoclassical loanable funds fallacy, to the effect that they somehow compete with corporate bonds for scare savings and drive up interest rates. It feeds the neoliberal delusion that government debt is a future burden that could potentially somehow bankrupt the currency issuer. While all money is a form of debt, the words ‘debt’ and ‘money’ have different associations, and as Keynes said: ‘we can draw the line between “money” and “debts” at whatever point is most convenient for handling a particular problem’. The problem here is to counteract a misleading but deeply ingrained view of public finance. For this purpose, we should never use the word ‘debt’ when discussing monetary sovereign financial liabilities. They are not debts, in the conventional sense of the term. They are better viewed as a form of broadly defined vertical (or outside) money, or as the net financial assets of the non-government sector. This means it is better to avoid the issuance of government debt securities, such as government bonds, treasury bills or treasury notes. This could be done without changing anything of significance for the monetary system, other than perhaps the elimination of some rent-

seeking activity in private financial institutions. It would simply clarify our discussions of fiscal policy.

Warren Mosler has often compared treasury bonds to transferable savings accounts at the Fed. That is exactly what they are. It would be useful to replace them with term deposits at the Fed. The ability of the central bank to control official interest rates across the entire yield curve would become transparent. There could never again be misleading discussions of investors going on bond strikes, driving up the yield on treasury bonds to levels which people wrongly assume to be unsustainable, or anything of that kind. There would be a simpler, more transparent, more efficient approach to public finance.

The fallacies of the neoclassical loanable funds view of interest rates and the related myths about fiscal sustainability and crowding out, would be seen to be nonsensical. Neoliberal narratives would be undercut. We could get on with having a rational and well-informed discussion about issues such as the appropriate role and size of the government within the economy; the appropriate design of more effective automatic stabilisers like the job guarantee; and how to plan and to pay for a rapid transition to a future of genuinely (ecologically) sustainable prosperity, free of the mistaken notion that our most pressing constraint is somehow a shortage of money, or an accelerating national debt.

Monetary sovereign government debt securities belong in the history books

Stop issuing monetary sovereign government debt securities. They are unnecessary. There is no compelling reason to issue them. They confuse people. They bias macroeconomic discourse, policy making and outcomes. They are an anachronism. They belong, alongside tally sticks, the gold standard, the London discount houses, and neoclassical macroeconomics, in the history books.

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