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A primer on fiscal deficits and central bank financing: Reasons not to fear them - Jesus Felipe and Scott Fullwiler

The severe economic downturn caused by the coronavirus disease (COVID-19) pandemic has forced governments worldwide to increase spending as tax revenues simultaneously collapsed. According to the Asian Development Bank's (ADB) COVID-19 Policy Database, as of 15 June, its 68 members had announced packages that amount to a total of almost $23 trillion. About $3.2 trillion corresponds to the announced packages of its 46 developing members, with 46% of this amount, or $1.46 trillion, as direct support to income (spending, tax cuts, etc.).

While the increase in government support is welcome and understood as necessary to fill the gap as private economic activity plummets, the accompanying government deficits cause significant discomfort to many. This is interesting because they are two sides of the same coin. You cannot have one without the other. Nevertheless, most think fiscal deficits eventually have consequences such as higher inflation, higher interest rates, reduced funds available to finance private sector investment, and a burden on future generations. A common comparison is to equate government deficits to poor "housekeeping." Good governments, like financially sound households, the comparison goes, keep their budgets under control, and, even better, run surpluses to save for the future.

We disagree with these arguments. In fact, we believe they tilt toward being seriously wrong. We do admit that there is an understandable fear of deficits given some past experiences. Today's situation, however, has no resemblance whatsoever with those the reader may have in mind (e.g., Asian Financial Crisis, Zimbabwe, Weimar Germany).

The reality is the crisis is a problem for the private sector's (households, financial sector, and non-financial businesses) ability to pay its bills, not for the public sector (deficit). Thus, policy makers should worry about the former more than the latter. If it deteriorates significantly during the crisis (as is already happening), the aftermath will be far worse, and ironically could be accompanied later by far larger government deficits.

In fact, a deficit for the total private sector, in which all sources of income are less than all outlays, often precedes a crisis. Prior to the 1997–1998 financial crisis, for instance, private sectors of the most affected East Asian economies were in persistent deficit. Governments were frequently in surplus. If there is something to watch, it is the position of the private sector.

We also know the deficits and surpluses of the private sector and government are intimately related. Indeed, absent a current account surplus (the case of many economies during the crisis), the private sector can only be in surplus if the government sector runs a deficit. This follows from the national accounts relationship that the respective deficit or surplus positions of the private sector (private saving-investment gap), government (fiscal position), and the rest of the world (negative of the current account), sum to zero by definition. There is no avoiding this, short of suspending the laws of elementary-level math.

One must recognize that a government deficit adds to private sector savings. This should be uncontroversial. Government spending (or lower taxes) materializes via an electronic credit to accounts of households and businesses, raising their savings in-kind. If the government spends 100 units of the domestic currency and receives 90 units in taxes, there is a deficit of 10 units that is also a net credit to bank accounts of households and businesses.

Arguing that deficits necessarily bring increases in interest rates and/or reduce private sector investment is wrong on technical grounds—that is, the operational realities of a country's Treasury and central bank, specifically the bookkeeping entries in their respective balance sheets. Let's see what these realities are.

The 10-unit deficit in the example above represents excess balances for banks' accounts at the central bank. Banks transfer and borrow or lend these balances among each other to settle their customers' payments. They also use them to intermediate payments between the government and the non-bank private sector.

Left circulating, these additional balances would push down the short-term interest rate that the central bank normally manages (which serves as a reference rate for many other interest rates in the economy). This is just supply and demand—increase the supply banks have available to lend and the price of the loans (the short-term interest rate) falls. The central bank cannot let the rate fall below its target. But how?

The government will issue 10 units of its own bonds, and this way drain the 10 units that banks hold in their central bank accounts. This reverses, or "sterilizes," as economists prefer to say, the downward pressure on the short-term interest rate, returning it to where the central bank's own operations had put it. This is the operational reality of central banks and government.

There are two important implications. One is that while most think government bond sales finance deficits, operationally they actually support the central bank's daily operations to manage interest rates. According to a given country's laws, the Treasury and central bank will always coordinate and issue a risk-free asset to the private sector (or increase the interest rate offered on reserves) to mop up the excess that central bank balances deficits create.

The other is that spending, taxes, and bond sales all settle through banks' accounts at the central bank—it isn't *your* money that settles your tax liability or buys bonds. Your bank uses the central bank's money to do these on your behalf. If your bank's balance at the central bank isn't sufficient to settle your tax liability with the government, the bank will borrow from the central bank or from another bank that has done so.

All this brings us to the following question: does the government need bond sales to finance a deficit, or does the central bank need the sales to manage interest rates? It is the latter. We are seeing this answered in real time by central banks around the world as they lend directly to governments or purchase government bonds themselves to support government responses to COVID-19. In every case, central banks reverse the effects of the deficits that they finance and the balances their bond purchases create by issuing their own interest-earning liabilities or paying interest on the excess balances (another option is to let the excess balances push the interest rate to 0 if that's the central bank's new target rate).

The spending-draining operations of central banks and Treasuries effectively lead to the same outcome. We are used to this being the Treasury's job. Now we see that deficits without bond sales, or bonds issued that the central bank then purchases, means the central bank itself sterilizes the deficit in order to manage liquidity and short-term interest rates. Government deficits without government bonds—"printing money"—are in reality *always* "sterilized" (i.e., drained).

The outcome is no different even for the very unique case of Singapore, whose government is drawing on past reserves as it responds to COVID-19 rather than incurring deficits. Operationally, however, spending from past reserves is effectively an unremoved increase in banks' balances at the Monetary Authority of Singapore (MAS), which will then mop up as necessary to manage liquidity conditions. While "pre-funding" sounds to many like "better housekeeping," operationally there is no way around the fact that either Singapore's government or MAS (or both) will end up with more interest-bearing liabilities outstanding.

Where does all of this leave us? First, basic national accounting shows that deficits raise private savings. Second, rather than raising interest rates, deficits actually put downward pressure on interest rates by directly adding to banks' accounts at the central bank. Third, the central bank and government coordinate daily to drain deficits in order to achieve the former's interest rate target. Fourth, basic operational realities tell us there is no "printing money" without "sterilization"; the size and composition of a deficit matters for inflation, while the method of finance does not. Fifth, deficits, however financed, simultaneously increase recipients' income and provide risk-free, liquid, interest-bearing liabilities to investors. The so-called national debt is thus part of the private sector's most liquid, lowest-risk financial wealth, and the former cannot be eliminated without getting rid of the latter.

To close, we return to the real macroeconomic issue of COVID-19: the ability of the economy to bounce back depends on how quickly businesses and households can return to the pre-COVID-19 state (or better) of cash inflows relative to outflows. Absent large current account surpluses and without significant fiscal support, the private sector will move into deficit. The alternative is large fiscal deficits that enable the private sector to avoid its own deficits. In either case, the true danger becomes longstanding fears of deficits that are inconsistent with operational realities and run the risk of sacrificing the private sector's financial stability in pursuit of "good fiscal housekeeping."

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