Currency Regimes, Inflationary Pressures, and Fiscal Space Constraints

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EMPLOYMENT GUARANTEE POLICIES:
RESPONDING TO THE CURRENT ECONOMIC CRISIS AND CONTRIBUTING TO LONG-TERM DEVELOPMENT
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Why stimulus (and ELR) won't work

- Similar to argument against government deficit
  - can't be financed – bond market vigilantes
  - raises interest rates, reduces private investment
  - reduces private savings and investment – crowding out
- Causes excess demand
  - causes inflation
  - causes increased imports, external deficit
  - causes depreciation and thus inflation
- Increases government debt
  - Immoral transfer of burden of the debt on our grandchildren

Economic Framework

- Traditional View:
  - Business needs to Save to make investment
  - Banks need to get reserves to make loans
  - Governments need to sell bonds or levy taxes to finance expenditure
  - Households need to save to consume
  - Money is a commodity or commodity substitute
- BUT: all savings spent: Income = Expenditure
- No excess production – produce to exchange for something – supply = demand

Alternative Economic Framework

- Keynes, Schumpeter Dynamic View:
  - Business finances investment with bank credit
    - Investment creates income creates saving
  - Banks lend to firms and then seek reserves
    - Reserves are endogenous
  - Governments do not need to finance expenditure
    - Governments cannot be insolvent
    - Financing is part of interest rate policy
  - Money is a liability of the State, held because it is required to meet tax liability
    - If households hold money as an asset, governments must run deficits

What is money?

- Money is just a special commodity
- Money is a debt
  - Anyone can issue debt – IOUs
  - Whose debt will serve as money?
- Chartalist – State Money –Modern Money
- In the modern state each citizen has an original sin: liable to tax
- State determines what will extinguish that liability – the liability that it gives you when it spends by buying your output
- You have to sell services to the State to acquire the liability required to extinguish your tax liability

How does the government finance expenditure?

- Government spending is required to allow citizens to acquire the liability required to pay their taxes
- The liability is created by the central bank creating a credit in the Treasury account
- When the government spends the account is debited and a citizen’s deposit account is credited
- When tax is paid the citizen’s account is debited and the government account is credited
- The government does not need to borrow – the circuit closes: Taxes equal expenditure

State money is not commodity money

- Commodity Money: Gold Standard
- Commodity Money: Fixed exchange rate
  - you have to earn the foreign exchange
  - external constraint
  - The major problem facing developing countries
    - External borrowing only makes it worse
    - Debt burden

Why government must run a deficit

- If citizens are to be able to pay tax, the government must spend as much as it taxes – balanced budget
- If government spends less than it taxes citizens go to debtors prison!!
- If citizens hold some government liabilities for convenience—security purposes, then it must spend more than it taxes
- The government must run a deficit if the income elasticity of money is greater than 1

What determines interest rates?

- When government spends it credits a private bank account
- This creates excess reserves for the receiving bank
- It tries to lend these reserves in the interbank market, creating excess supply
- Short-term interest rate would fall to zero bid unless the government offered to borrow the funds
- The Government/Central bank thus have control over the interbank policy interest rate
- They can influence other rates by borrowing at other maturities (currently under quantitative easing!)
- Thus government does not need to borrow and interest rates do not need to be positive!

Why government cannot default

- As long as the government is the sole issuer of its currency and is the sole taxation authority it can always credit a bank account to make a payment
- It cannot default unless it chooses to do so
- (or in the case of the US it has a self-imposed limit on the absolute size of the government debt –which is also self-imposed and has always been increased to meet spending needs)

How do banks lend?

- Banks follow the same procedure – they make a loan by granting a client a deposit account credit
- They then look for the reserves to fund their new deposit liability
- They borrow in the interbank market, seek more deposits, or borrow in other ways – from the Fed
- Thus the Fed always provides the amount of reserves required to fund the lending already made by the bank – otherwise banks could not make payments

External constraints: Fixed exchange rates

- Under a fixed rate system the Government pledges to convert its own liabilities into something else – gold or foreign currency that it cannot create
- Government can now default!
- Government expenditures can be constrained by external deficits

External constraints: External Borrowing

- An external deficit under fixed rates is the same as external borrowing
- External borrowing under flexible rates can create additional volatility on the exchange rate and on capital flows
- Might require management of capital flows

Burden of the Debt on Our Grandchildren

Transfer problem:

If we fail to pay full price, how can our offspring send resources back to us so we can pay it?

War reparations: We never asked Japan to pay war debts, but they have been sending us goods ever since in exchange for our debts!

Costs of ELR?

- Deficit is not the problem
- Interest rate is not the problem
- Estimates of total costs – around 1% of GDP are not the problem
- External Constraints may be a problem:
  - May require management of capital account

Thank you

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