Can governments afford the debts they are piling up to stabilise economies?

Yes It poses no inherent danger to states that issue their own currency

Stephanie Kelton

The Covid-19 pandemic has forced governments around the world to spend large sums in an effort to stabilise their economies. Gone, for now, are concerns about how to "pay for" it all. Instead we are seeing wartime levels of spending, driving deficits — and public debt — to new highs.

France, Spain, the US and the UK are all projected to end the year with public debt levels of more than 100 per cent of gross domestic product, while Goldman Sachs predicts that Italy's debt-to-GDP ratio will soar above 160 per cent. In Japan, Prime Minister Shinzo Abe has committed to nearly $1tn in new deficit spending to protect a $5tn economy, which will push the debt ratio well above its record 237 per cent. With GDP collapsing on a global scale, few countries will escape. In advanced economies, the IMF expects average debt-to-GDP ratios to top 120 per cent in 2021.

While most see big deficits as a price worth paying to combat the crisis, many worry about a debt overhang in a post-pandemic world. Some fear that investors will grow weary of lending to cash-strapped governments, forcing countries to borrow at higher interest rates. Others worry governments will need to impose painful austerity in the years ahead, requiring the private sector to tighten its belt to pay down public debt.

They should not. While public debt can create problems in certain circumstances, it poses no inherent danger to currency-issuing governments, such as the US, Japan, or the UK. This is not, as some argue, because these countries can currently borrow at very low cost, or because a strong recovery will allow them to grow their way out of debt.

There are three real reasons. First, a currency-issuing government never needs to borrow its own currency. Second, it can always determine the interest rate on bonds it chooses to sell. Third, government bonds help to shore up the private sector's finances.

The first point should be obvious, but is often obscured by the way governments manage their fiscal operations. Take Japan, a country with its own sovereign currency. To spend more, Tokyo simply authorises payments and the Bank of Japan uses the computer to increase the quantity of Yen in the bank account. Being the issuer of a sovereign currency means never having to worry about how you will pay your bills. The Japanese government can afford to buy whatever is available for sale in its own currency. True, it can spend too much, fuelling inflationary pressure, but it never needs to borrow Yen.

If that is true, why do governments sell bonds whenever they run deficits? Why not just spend without adding to the national debt? It is an important question. Part of the reason is habit. Under a gold standard, governments sold bonds so deficits would not leave too much currency in people's hands. Borrowing replaced currency (which was convertible into gold) with government bonds which were not. In other words, countries sold bonds to reduce pressure on gold reserves. But that's not why they borrow in the modern era.

Today, borrowing is voluntary, at least for countries with sovereign currencies. Sovereign bonds are just an interest-bearing form of government money. The UK, for example, is under no obligation to offer an interest-bearing alternative to its zero-interest currency, nor must it pay market rates when it borrows. As Japan has demonstrated with yield curve control, the interest rate on government bonds is a policy choice.

So today, governments sell bonds to protect something more valuable than gold: a well-guarded secret about the true nature of their fiscal capacities, which, if widely understood, might lead to calls for "overt monetary financing" to pay for public goods. By selling bonds, they maintain the illusion of being financially constrained.

In truth, currency-issuing governments can safely spend without borrowing. The debt overhang that many are worried about can be avoided. That is not to say that there is anything wrong with offering people an interest-bearing alternative to government currency. Bonds are a gift to investors, not a sign of dependency on them. The question we should be debating, then, is how much "interest income" should governments be paying out, and to whom?

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No This dangerous monetary practice ensures inflation is around the corner

Edward Chancellor

How to pay for the fathomless costs of fighting a pandemic? All the state's expenses, whether a Green New Deal, jobs-for-all or the economic lockdowns, can be met simply by printing money. That is what modern monetary theory claims.

Adherents of this unorthodox school of economics would have us believe, like Alice in Wonderland, six impossible things before breakfast. Governments can never go bust. They don't need to raise taxes or issue bonds to finance themselves. Borrowing creates savings. Fiscal deficits are not the problem, they are the cure. We could even pay off the national debt tomorrow.

As theory, MMT has been rejected by mainstream economists. But as a matter of practical policy, it is already being deployed. Ever since Ben Bernanke, as governor of the US Federal Reserve, delivered his "helicopter money" speech in November 2002, the world has been moving in this direction. As president of the European Central Bank, Mario Draghi proved that even the most indebted countries need not default. Last year, the US federal deficit exceeded $1tn at a time when the Fed was acquiring Treasuries with newly printed dollars — that's pure MMT.

This crisis has accelerated the process. Fiscal and monetary policy are now being openly co-ordinated, just as MMT recommends. The US budget deficit is set to reach nearly $4tn this year. But tax rises are not on the agenda. Instead, the Fed will write the cheques. Across the Atlantic, the Bank of England is directly financing the largest peacetime deficit in its history. MMT claims that money is a creature of the state. The Fed's share of an expanding US money supply is close to 40 per cent and rising. Again, we are seeing MMT in practice.

The lockdown is a propitious moment to implement MMT. During crises, the public has an abnormally high demand to hold cash; debt monetisation appears less of a problem. But governments can print money to cover their costs for only as long as the public retains confidence in a currency. When the crisis passes, the excess money must be mopped up.

Proponents of MMT claim this shouldn't be a problem. But then they admit that nobody has a good inflation model. We cannot accurately measure the economy's spare capacity, either. This means that politicians are unlikely to hike taxes in time to nip inflation in the bud. Bonds can always be issued to withdraw money from circulation. But once inflation is under way, bondholders demand higher coupons. From a fiscal perspective, it makes more sense to issue government debt when rates are low — as they are today — than to print money now and pay higher rates later.

Great historic inflations have been caused not by monetary excesses but by supply shocks, say MMT exponents. It's likely that coronavirus will turn out to be one of those shocks. Besides, history casts doubt on attempts to explain inflation by non-monetary factors. The closest example of MMT in implementation comes from France's experiment with paper money. In 1720, the Scottish adventurer John Law served as French finance minister and head of the central bank. The bank printed lots of paper money, the national debt was repaid and France enjoyed brief prosperity. But inflation soon took off and crisis ensued.

The truth is that governments have an inherent bias towards inflation, especially under adverse conditions such as wars and revolutions. The Covid-19 lockdown is another such condition. Tomorrow's inflation will alleviate some of today's financial problems: debt levels will come down and inequalities of wealth will be mitigated. Once excessive debt has been inflated away, interest rates can return to normal. When that happens, homes should be more affordable and returns on savings will rise.

But the evils of inflation should not be overlooked. Economies do not function well when everyone is scrambling to keep pace with soaring prices. Inflations produce their own distributional pain. Workers whose incomes rise with inflation do better than retirees. Debtors will thrive at the expense of creditors. Profiteers arise, along with populists who feed on social discontents.

Modern monetary practices ensure another inflation is around the corner. MMT provides the intellectual gloss. It promises a free lunch. Even Alice shouldn't believe that.

The writer, a financial historian, is author of a forthcoming history of interest

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