The Effect of Monetary Sovereignty on Government Spending, Budget Deficits, and Public Debt

written by Leon Damian Leon Damian

The current COVID-19 crisis has led to debates about the problem of unsustainable government deficits and public debt. Many countries have increased spending and borrowing to keep their economies afloat during the global pandemic. The temporary closures of businesses and strict lockdown measures have led governments and central banks to introduce policies to mitigate the adverse economic effects of the pandemic. Governments worldwide have turned on the printing presses and increased borrowing to fund furlough payments, government grants, and tax cuts that help businesses and individuals weather the COVID storm.

The government deficits of major economies like the USA, the Eurozone, and the UK have increased substantially from pre-pandemic levels. As of 2020, the US's deficit was 14.9% of GDP, the UK's deficit stood at 11.9% of GDP, and the Eurozone's deficit was 7.2% of GDP. Such fiscal measures have been necessary to help revitalize economies worldwide suffering from catastrophic falls in aggregate demand. The fall in demand worldwide has drastically reduced global economic activity and taken many economies into severe recessions. In addition, prolonged lockdowns in countries like the UK have meant that economic activity has remained stagnant, resulting in fewer tax receipts and increased government spending in areas like unemployment benefits, business grants, and support for public services and households, and worsening deficits in many economies.

However, to fund such growing deficits, many major governments fiercely issue bonds to provide their economies with much-needed cash. Demand for government bonds such as US treasuries and UK gilts has surged as many investors have switched from risky debt securities to what is deemed a safe haven asset – government bonds. The increased demand in major economies for government bonds, especially in the US, has put downward pressure on interest rates, making borrowing cheaper. Furthermore, the increased supply of government bonds in many major economies has impacted public debt. The debt to GDP ratios of the USA, the Eurozone, and the UK have risen sharply from pre-pandemic levels in 2019. In the USA, debt to GDP increased from 106.9% to 107.6%, and in the Eurozone, it soared from 83.9% to 98% (Trading Economics 2021); while in the UK it rose from 84.4% to 97.4%. The situation has been mirrored worldwide. It was estimated at the end of 2020 that the COVID 19 pandemic had added $19.5 trillion to global debt (McCormick et al. 2021).

Such alarming figures have raised serious concern for many economists who fear that the rapid surge in debt will lead to years of heavy fiscal restraint. The fundamental question is what policies are necessary to help governments reduce colossal public debt and bring deficits down to what is considered healthy. The EU, for example, expects Eurozone countries to keep their public debt below 60% and deficits below 3% respectively. Because these countries do not have monetary sovereignty, they are restricted from implementing expansionary fiscal policies to offset economic downturns, such as increased government spending to boost aggregate demand. Likewise, Eurozone countries with such deficits are expected to implement austerity policies that further suck demand out of the economy when it needs it most.

The situation facing other major non-Eurozone countries such as the UK and the US isn’t too dissimilar. The UK as an ex-member of the EU, but not of the Eurozone, was monetarily sovereign even before Brexit, having its own currency and

central bank. Therefore, the UK has full power over its monetary policy, a valuable economic instrument to help it navigate its way out of economic downturns. However, like the Eurozone, the UK has followed pretty much the same economic narrative concerning deficits. In times of economic downturns, the UK government has opted to implement austerity policies of high taxation and reduced government spending to bring down the deficit.

On the other hand, the USA has had slightly higher economic growth since the Great Recession compared to the EU and the UK. The key factor in this increased growth was that austerity measures were implemented after the US economy was in a recovery phase, unlike in the UK and the Eurozone, where such measures were adopted when the economies were more fragile. In turn, this meant the US's fiscal multiplier was lower than the Eurozone's and the UK's, as budget cuts had less of an impact on the US economy. Nonetheless, the economic narrative was the same: reduce deficits and debt at all costs. Public debt in all three economies has increased significantly over the years; evidently, such neoliberal economic policies did not have the desired effect.

A Different Approach to Macroeconomic Thinking: Modern Monetary Theory

Modern Monetary Theory (MMT) is a relatively new approach to macroeconomic thinking. However, it is gaining notoriety especially given the current pandemic. One of the merits of MMT is the concept of monetary sovereignty, which allows for a more flexible fiscal policy. Monetary sovereignty means that a country with its own currency, central bank and debt denominated in its national currency can always increase its spending by issuing more currency. This means that the government does not rely on taxes nor needs to borrow to fund spending. A monetarily sovereign country has the monopoly to issue currency, thus printing as much currency as needed to a certain extent.

The current neoliberal approach to macroeconomic thinking requires governments to think of government budgets similar to that of household budgets. In macroeconomic terms, if the government spends more than it receives in tax revenues, it will have a deficit; in turn, the government will need to borrow to bring down the deficit, subsequently leading to an increase in public debt. The US and the UK narrative particularly states that if the government continues to spend beyond their means by running unsustainable deficits, they risk potentially defaulting on debt or even going broke. Such rhetoric is often espoused to justify austerity policies such as cuts in public spending and higher taxation, which exacerbate the severity of an economic downturn rather than remediate it.

The spread of COVID 19 has already caused a negative multiplier effect in many economies, leading to reduced trade and a general fall in confidence, resulting in a decrease in investment and travel. The pertinent question is, do governments worldwide have the economic tools to offset the economic devastation of the COVID pandemic?

The common neoliberal counterargument to printing more money is that increasing the deficit would lead the respective government to borrow to bring the deficit down, resulting in rising public debt. However, this is not a significant concern for such counties as the US and the UK as their debt is denominated in their own currency; thus, the risk of default is almost none. Another counterargument to MMT is that excessive spending will cause inflationary pressure leading to market disequilibrium where demand exceeds supply. However, as is the case in a recession, this will not happen as labour supply would exceed labour demand. Proponents of MMT are not advocating that governments should go on reckless spending sprees for eternity because, as mentioned before, inflation must be monitored. If inflation gets out of control, the private sector will have an excess of money, and the production of goods and services would be far less than the

supply of money, causing price hikes. The crucial point to consider here is how this money is used. Does the government pump it into the financial markets, inflating asset prices with no real trickle-down effect? Or is the money used to create jobs that, in turn, produce goods and services? The ability to produce more goods and services would be far more suitable as it increases money supply. However, the number of goods and services being produced in the economy would rise too, offsetting inflationary pressure in the economy.

The ethos around government spending and deficits for monetarily sovereign nations needs to be redefined. The prescribed remedy of contractionary fiscal policies has been the norm and justified by using the household narrative that too much spending will lead to default or bankruptcy. Budget deficits allow the private sector to save more; in essence, a budget deficit is the private sector's surplus as more money is injected into the economy than is being taken. The private sector can then use these savings to buy government bonds, a safe financial asset that pays interest. Thus, budget deficits act as an injection into the economy with a multiplier effect. Likewise, suppose a government runs a surplus or tries to bring its deficit down. In that case, this withdraws money from the economy and erodes the private sector's savings, subsequently making the population poorer. However, again, it is the private sector that determines the deficit. If the private sector spends more, higher tax revenues result in a lower deficit. Conversely, if the private sector saves more, this leads to higher deficits as less spending results in lower tax revenues.

Monetarily sovereign governments still religiously adhere to the notion that you have to tax before spending to keep the deficit in check. So why is taxation needed if it is not necessary for government spending? Firstly, inflationary pressure would set in if governments kept increasing their spending and printing money. Thus, the government needs to use taxation in conjunction with increased spending to restrain

the private sector from overheating the economy. However, it is vital to ascertain which specific taxes would relieve inflationary pressure and knowing when not to implement tax hikes as it would be counterproductive and reduce the effect of the fiscal stimulus.

Secondly, taxation is crucial to redistribute income. A progressive tax system helps with this, although it has had the opposite effect in countries like the UK and the US. For example, in 2018/2019 in the UK, 42% of disposable household income went to 20% of people with the highest household incomes, whereas only 7% was distributed to the poorest 20% (Francis-Devine 2021). The situation in the US is even worse; in 2019, 51.9% of US income went to the top 20%, whereas only 3.1% of US income went to the bottom 20% of the population (Amadeo 2021). Governments can use tax authorities to reduce such income inequality by raising rates, especially on the rich, clamping down on tax loopholes, and investing more in tax collection agencies would help bridge this gap. Although taxes are not vital for monetary sovereignty, they are a crucial tool that needs to be implemented to balance other areas of the economy to increase social welfare.

The Neglect of Fiscal Policy in Favour of Quantitative Easing

Central banks worldwide have been implementing Quantitative Easing (QE) programmes to tackle economic downturns. However, the results have been unconvincing. Quantitative easing is a tool central banks use to print money to buy government bonds or corporate bonds. The purchase of such bonds increases the price of bonds and lowers their yields (interest rates). The reduced interest rates are supposed to trickle down into the rest of the economy by lowering interest rates for households and businesses. As a result, lower interest rates should boost spending and increase aggregate demand, leading to economic growth and reducing unemployment.

However, the desired effects have not come to fruition as EQ

has inflated the price of financial assets as the markets have had access to cheap credit, which has flooded the financial markets. In the UK, the Bank of England has printed money in excess of 18% of GDP (Bank of England 2021); the FTSE has increased by 35%, and real estate prices have risen by around 9% (Premsingh 2021); however, the consumer price index has only marginally increased from 1.5% to 2%. In essence, all that the latest round of QE has done is widen the inequality gap; in the UK, the wealthiest 10% of the population own roughly 45% of the country's assets. Thus, flooding the financial markets with cheap credit has led to overinflated asset prices and exacerbated inequality. The never-ending cycle of pumping the financial markets with QE every time markets drop below a certain threshold, generally around 20%, has become common practice. Although QE a is a relatively new phenomenon, it has been implemented more than ever since the 2008 financial crash. The core reason for its newfound popularity is that interest rates have been around zero levels bound since the financial crash in 2008, as conventional forms of monetary policy have been ineffective in negating the economic downturns. However, in its current state, QE is extremely dangerous as it has perpetually inflated asset prices, subsequently creating asset bubbles that eventually burst. When asset bubbles burst, central banks step in and reflate the markets with cheap credit, and the habitual cycle repeats.

Cryptocurrencies and the Base Interest Rate

Central Banks are a relatively new phenomenon and have a monopoly over setting the base interest rate. For example, the Federal Reserve was established in 1913 and has since been the custodian of inflation and employment. Under its stewardship, the US has experienced 20 recessions lasting around 30 years. Cycles of boom-and-bust may seem a natural part of economic reality. However, they are ultimately an expression of bad policymaking. The free banking era of 1837 to 1866 in the US, where any economic entity could issue legal tender that could

be used for the exchange of goods and services, offers a precious experiment into a different economic structure, where the interest rate was not set, but rather determined by market forces. A century and a half later and this industry has resurfaced. The cryptocurrency revolution offers to undermine the monopoly power that the Central Bank has over interest setting. However, their implications in monetary sovereignty are unclear. Monetary sovereignty has taken on a new meaning; not only national but also entity-based, as anyone can issue a cryptocurrency.

The phenomena of cryptocurrencies show that parallel currencies can coexist and perhaps even diverge, creating the possibility of multiple interest rate regimes. This could improve the targeted effectiveness of monetary policy mechanisms. The traditional one-size-fits-all mechanism may be altered through specific entities or regional issuances. If cryptocurrency becomes an accepted legal tender, the CB will effectively lose its ability to control the money supply and conduct Monetary Policy. Instead, the new monetary custodian becomes the market with fluctuating interest rates that quickly react to exogenous economic inputs. This may prove a far more efficient mechanism for avoiding asset bubbles with a clearer price-incentive mechanism for investment.

There are dangers, of course and these are even harder to gauge. The opportunity for fraudulent behaviour is vast. Technological differences between different areas may act as a barrier to the implementation of an economy-wide crypto structure. Furthermore, existing macro-imbalances at regional and industry levels of productivity and labour market sophistication may favour the winners first. The eventual balancing in investment flows, therefore, may come at the cost of a generational effort of the appropriation of a digital economic structure. As industry suffered from the emergence of the service market, so may some parts of the economy suffer from the adoption of a new system of exchange.

Creating Productive Jobs in the Real Economy

Instead of creating asset bubbles with cheap liquidity from central banks, a better solution would be to use MMT. MMT would focus on increasing government spending on public infrastructure and public services and ensure enough employment in the economy. Furthermore, there is a misnomer that financial restraints prevent such provisions from being implemented in the economy. In truth, the only restraints are resource restraints and inflation concerns that need to be seriously considered. Concerning the inflation issue, some key areas for investment could improve the economy's productive capacity and keep inflation down. For example, investment in green infrastructure would help offset inflation by reducing the risk of rising input costs for major economies (Kelton 2020). Additionally, investment in digital infrastructure would boost productivity, which, in turn, means workers could be paid more without causing inflationary pressure.

Another solution MMT proposes to reduce unemployment and create a stable and robust economy is implementing a Job Guarantee Scheme. Such a scheme would provide employment opportunities in the public sector to anyone willing and able to work. In effect, a job guarantee scheme would act as a buffer stock scheme where if there is too much unemployed labour, the government will buy up the excess at a fixed price, which would be at the lower end or below the private sector wage structure (Williams 2018). The idea of trying to offer employment to anyone willing and able to work may seem revolutionary as the economic narrative for many years has advocated that unemployment is a necessary evil. However, a monetarily sovereign government could increase its spending to whatever is required to maintain full employment, especially when it has debt in its own currency. The argument that such a policy would increase inflation is valid to an extent, however as mentioned earlier, not if it spends money to create jobs that also increase the number of goods and services in the economy, thus offsetting inflation.

Classical economists point out that unemployment acts as an economic stabilizer for wages and consumption levels to prevent inflation. However, the government controls the unemployment rate simply by changing the levels of taxation and spending. In effect, governments generally create the rate of unemployment that NAIRU (Non-Accelerating Inflation Rate of Unemployment) demands, which is the lowest level of unemployment that can happen in an economy before inflation begins its unstable trajectory.

The scheme would act as an automatic stabilizer that stabilizes economic activity when aggregate demand falls to a level that cannot maintain the full employment level. During economic downturns, the job guarantee scheme would expand, whereas, during an economic boom, it would contract as workers would transition into the private sector. Thus, the job guarantee scheme evens out the fluctuations in the business cycle, keeping wage and consumption levels stable. When in an economic downturn, the unemployed would be offered a chance to work in the public sector. This acts as a transition job until the economy picks up and workers can transition back into the private sector. The ability to stay employed and earn a living wage is beneficial for society making the worker more employable with no prolonged periods of unemployment (Kelton 2020).

All in all, economic policy needs a total reset; the obsession with inflation and the neglect of growth and unemployment is burdening societies with economic hardships to justify harsh policies such as prolonged periods of fiscal austerity, reduction in government spending, and deregulation. The current neoliberal economic model implemented worldwide is set up to benefit the few, not the many.

This political narrative that shapes economic policy is misguided, treating monetarily sovereign nations as simple currency borrowers rather than currency issuers and opts to manage a macroeconomy like a household with significant

financial restraints. The aftermath of financial crises has been harsh contractionary fiscal and monetary policies that have prolonged recessions and downturns. The political and economic ideology of dealing with downturns needs to change. Modern Monetary Theory offers a new alternative to weathering economic storms and highlights the importance of fiscal policy during downturns. MMT allows government spending in green energy, lowering unemployment, infrastructure, and education without the narrative that higher taxes and borrowing are needed to fund such initiatives; monetarily sovereign governments can use money from their central bank. Government spending needs to play a more active role in economic downturns and recessions, and the recent pandemic has reinforced that notion.

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