WHAT IS MONEY AND WHY AUSTERITY CAN NEVER WORK

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What Is Money?

- In theory, all of us can issue an IOU (or a “liability”). In Canada, until the founding of the Bank of Canada in 1934, commercial banks issued their own private bank notes that circulated. The notion of a Bank “Charter” (and a “Chartered” bank) originates from the Latin word: “**Charta**” or “**Carta**” which means issuing a “paper” note that would be generally accepted and circulate as currency.
- Hyman Minsky (1986, p. 228) wrote: “**everyone can create money; the problem is to get it accepted.**“ Money rests on trust!
- Hence an IOU needs to be “accepted” or it wouldn’t circulate! But why would people accept it? The answer is that people won’t normally. But what will encourage the public to “accept” a private (commercial bank) or a government-issued IOU?
- To explain this there are two broad and conflicting historical traditions in monetary economics: the “mainstream” and the “non-mainstream” view.

What Is Money?

- **The oldest tradition is the Non-Mainstream: the Chartalist (or Cartalist) tradition**
- It originates in antiquity, which relies on the power of the State through its legal system in enforcing “legal tender” money.
- In all organised societies where there exists a state authority, the State must command resources. The Money that it issues emerges as an “order” on the system of production to access goods and services.
- But why would anyone want to give up private real resources voluntarily to accept the State’s IOU in return? Because you must pay your taxes with what the State authority deems to be “legal tender”.
- In ancient societies in which monetary exchange was not central (as it is now modern capitalist economies), this system worked and was uncontested, since taxes were often collected in kind and monetary exchange was marginal to their main agricultural activities within these local rural communities.

What Is Money?

- **The mainstream Metalist tradition**
- It originates in the Middle Ages, as societies were engaging in greater commercial activities, with a rising merchant class, ever greater conflict with state taxation was also manifesting itself.
- All these conflicts arose especially during the 13th and 14th centuries, because of the dominance of commodity money (precious metals), that is, before the invention of the Gutenberg press in the mid-15th century.
- Chartalist theory gave the right to the King (or the Prince) to issue coins in the kingdom. However, these cash-strapped authorities in search of liquidity were often tempted to modify the precious metal content of coins, which the rising bourgeoisie or merchant class saw as a hidden source of "indirect" taxation in the hands of the State.
- This is the period when the so-called "Gresham's law" appeared: "**Bad money chases good money out of circulation**".

The Mainstream Metalist Tradition

- It is from these medieval debates over the nature of commodity money there came the notion that, whether it is coins or paper currency, this **fiduciary** (or "trustworthy") money must be fully backed by precious metals, from which came the term "**metalism**" or "**bimetallism**" (if it's monetary system based on gold and silver).
- Hence, even with the invention of paper currency (including government or private bank notes) that is "**scriptural** money", these paper currencies had to be backed by reserves of precious metals.
- In fact, a whole international monetary system was developed by the 19th-century referred to as the "gold standard": each country would fix its currency price of gold (which meant an international fixed-exchange rate system) and, each country's central bank would only issue currency based on its gold reserves (or other precious metals, if bimetallism).

The Mainstream Metalist Tradition

- This system worked somewhat in good times but was dysfunctional in bad times.
- For instance, the amount of liquidity in the system depended on gold discoveries (example, the Klondike).
- But, normally, it would be a deflationary/disciplining device because whenever a country got into a balance of payments problem and ran, say, a trade deficit, it would have to deflate (leading to social conflicts as happened in Britain with the famous coal miner's strike in 1926).
- Moreover, every time there was a war (WW I), governments would abandon it.
- In fact, the gold standard collapsed in 1931 and countries never went back to it.
- Although there were different international monetary systems that followed (such as the **Bretton Woods system**, after WWII, and the current multipolar world), for over the last half-century, there are no longer traces of commodity-based systems.
- The closest was in the 1970s-1980s, when central banks adopted **Monetarism** which pretended "as if" money is a commodity that central banks can control directly, by means of controlling central bank base money, but they failed.

What Is Modern Money?

- **Two quotes**: "'Money' is the by-product of a balance sheet operation of a third agent who, in modern parlance, can be dubbed a 'bank'. In particular, money always emerges as a debt (or liability) issued by this third agent on itself, which has as counterpart a credit simultaneously granted to buyers of goods and services within an economy. In this three-way balance sheet relation, every transaction entails the simultaneous creation or destruction of debt, and every seller of goods and services accepts payment of this bank liability on the basis of its general purchasing power or value." (Parguez and Seccareccia (2000, p. 101)
- " … money emerges both causally and historically as a result of prior debt and credit relations. Money appears when a community (usually through the legal apparatus of the state) bestows the characteristic of being a legal title to a share of present and future wealth on debts issued by a specific agent." (Parguez and Seccareccia (2000, p. 101)

The Monetary Circuit, Highlighting the Functioning of the Private Bank Money System

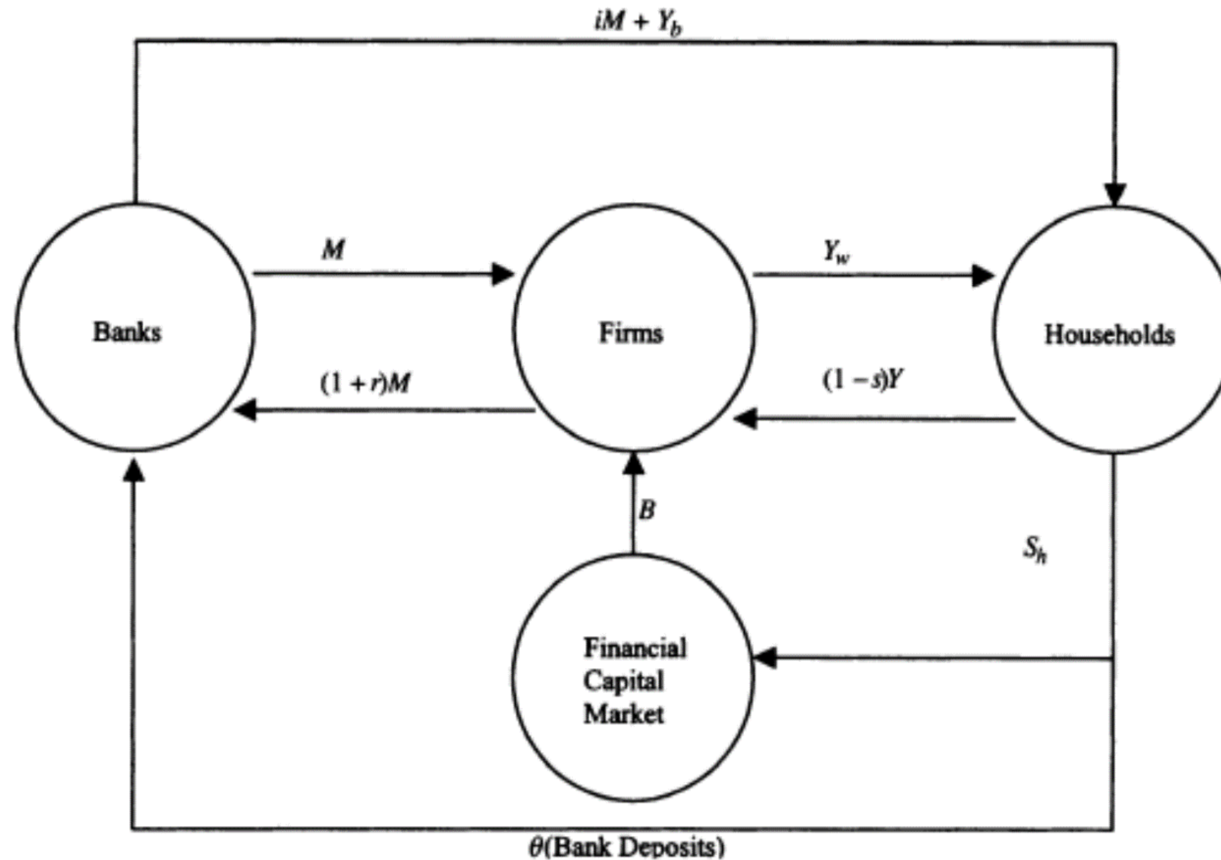


Figure 1. Monetary Flows Among Banks, Firms, and Households

The Monetary Circuit, Highlighting the Interaction between the Public and Private Sector

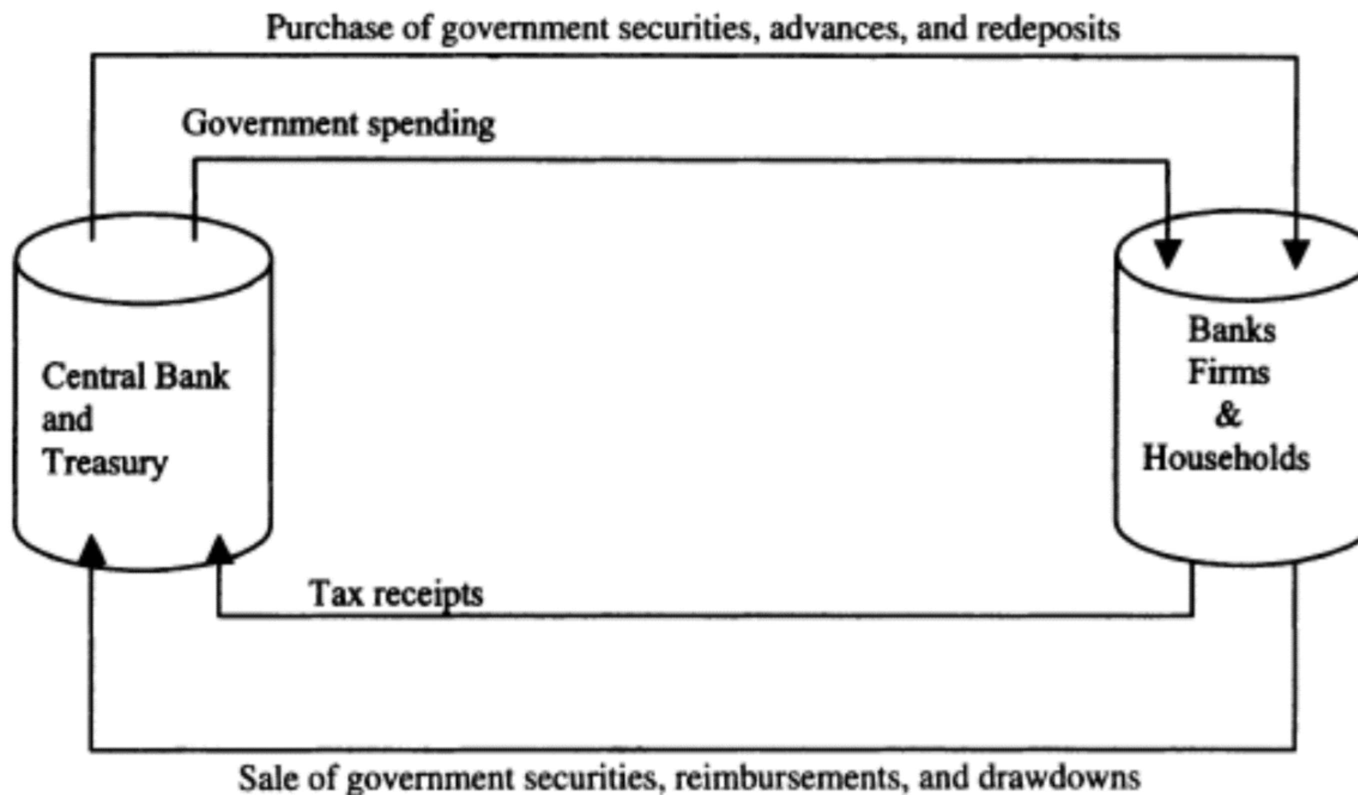


Figure 2. Flows of Funds: Central Bank, Treasury, and Private Sector

The National Accounts and the Net Sectoral Balances

- **Every receipt must be an expenditure of someone else**.
- **$C + I + G + X\text{-}M = Y$** (Expenditures = Receipts)
- If we re-organize and subtract taxes, T, from each side:

  $$Y\text{-}T = C + I + (G\text{-}T) + (X\text{-}M)$$

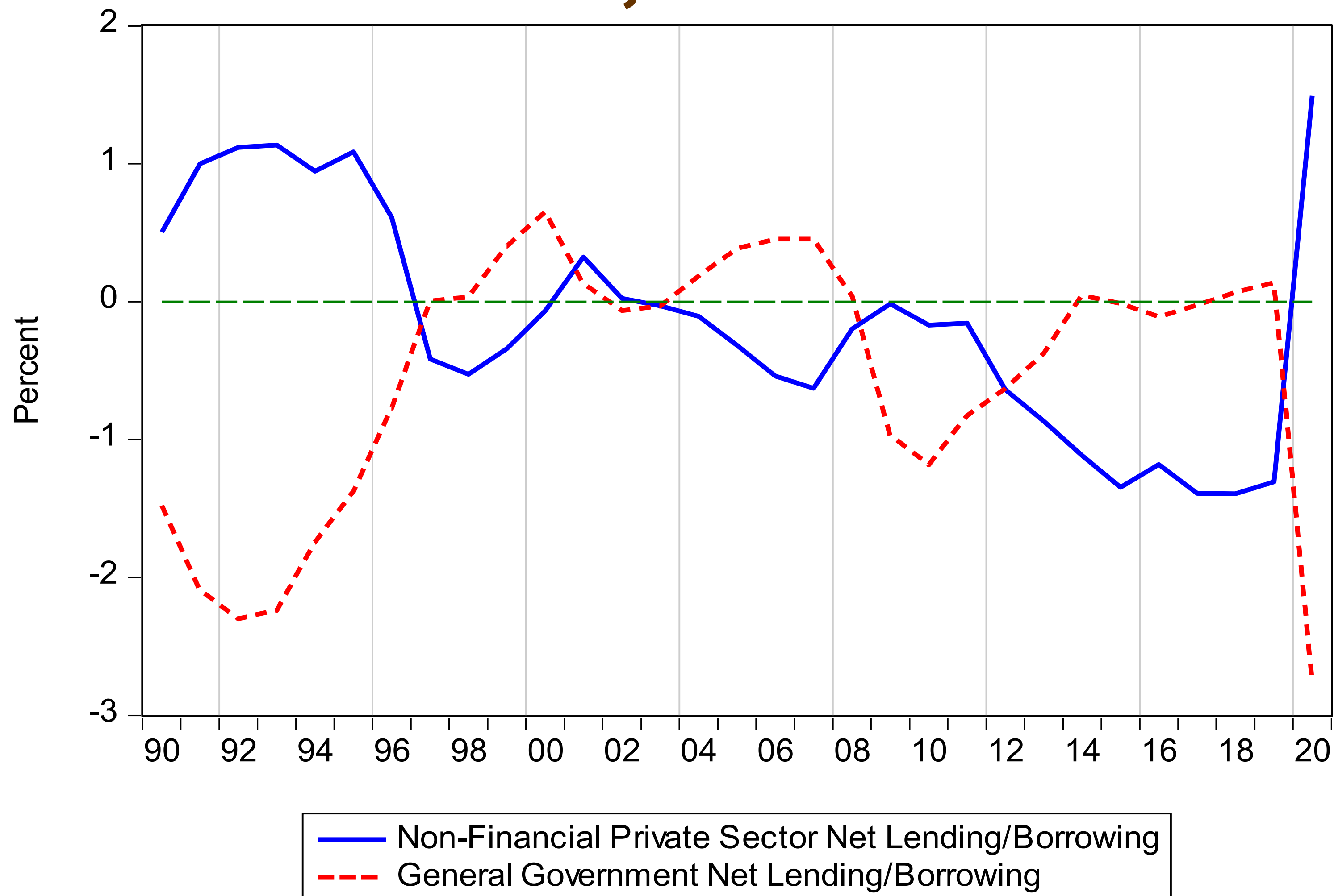
- If we subtract consumption expenditures, C:

  $$Y\text{-}T - C = I + (G\text{-}T) + (X\text{-}M)$$

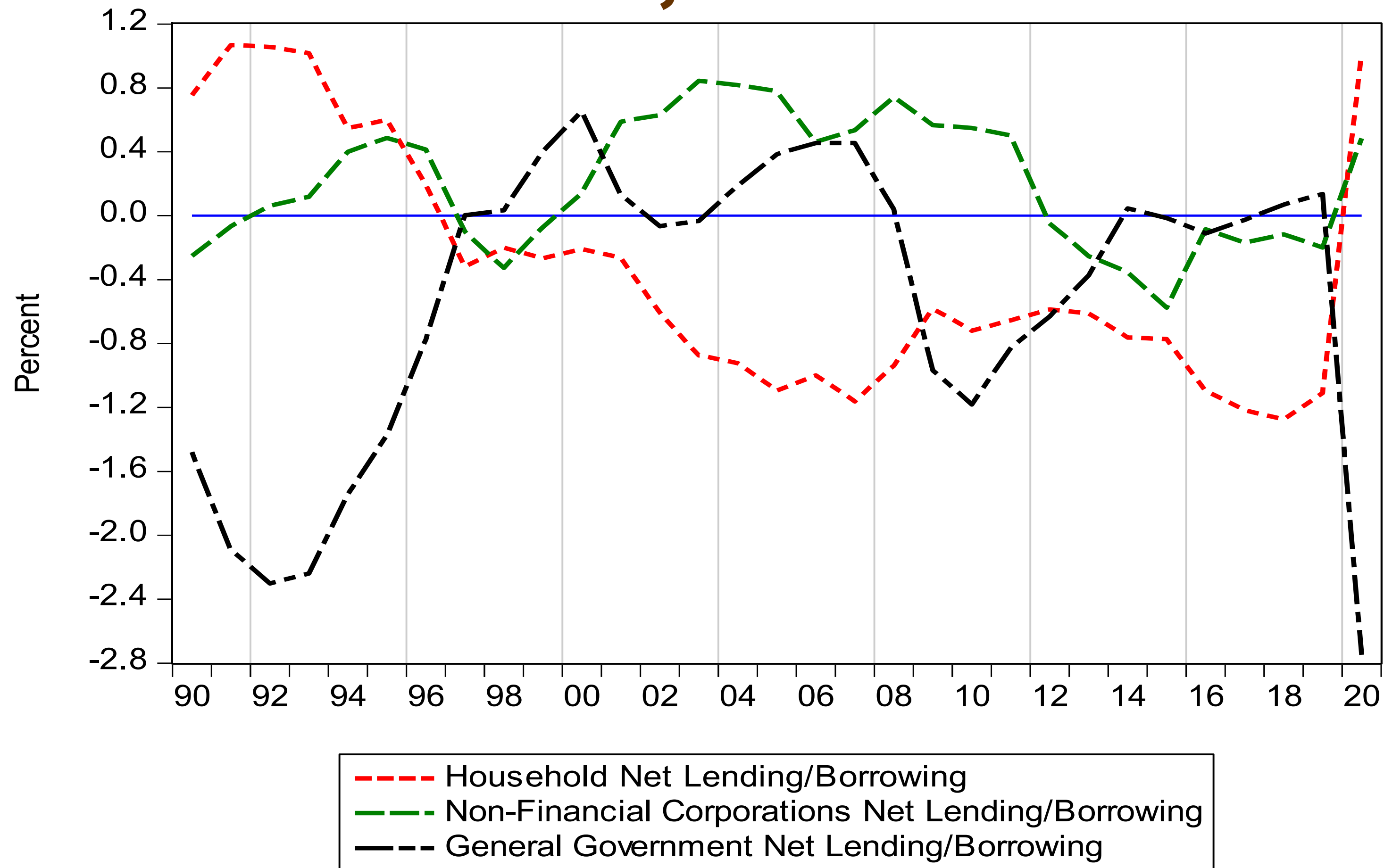
  $$S = I + (G\text{-}T) + (X\text{-}M)$$

- **$(I\text{-}S) + (G\text{-}T) + (X\text{-}M) = 0$** (the Godley equation)
- If $(X\text{-}M) = 0$ (let us assume a foreign sector current-account balance), we obtain:
- $(G\text{-}T) = (S\text{-}I)$ [**the government budget deficit = the net private sector saving**]

Net Lending/Borrowing by Sector Canada, 1990-2020

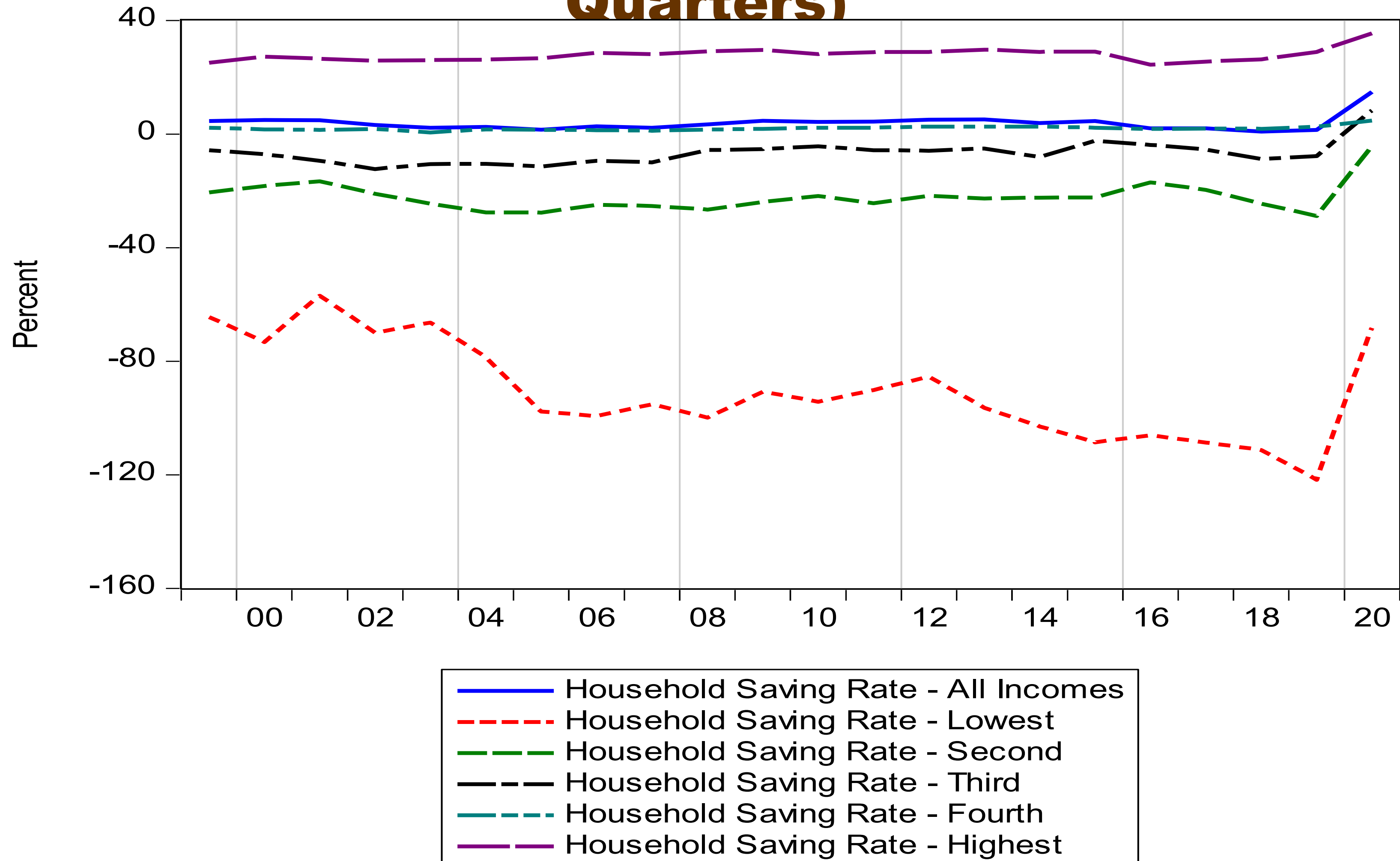


Net Lending/Borrowing by Sector Canada, 1990-2020



Source: CANSIM Database, Series V62690908, V62691154, V62691482, V62305783

Household Saving Rate by Income Group, Canada 1999-2020 (2020 - First Three Quarters)

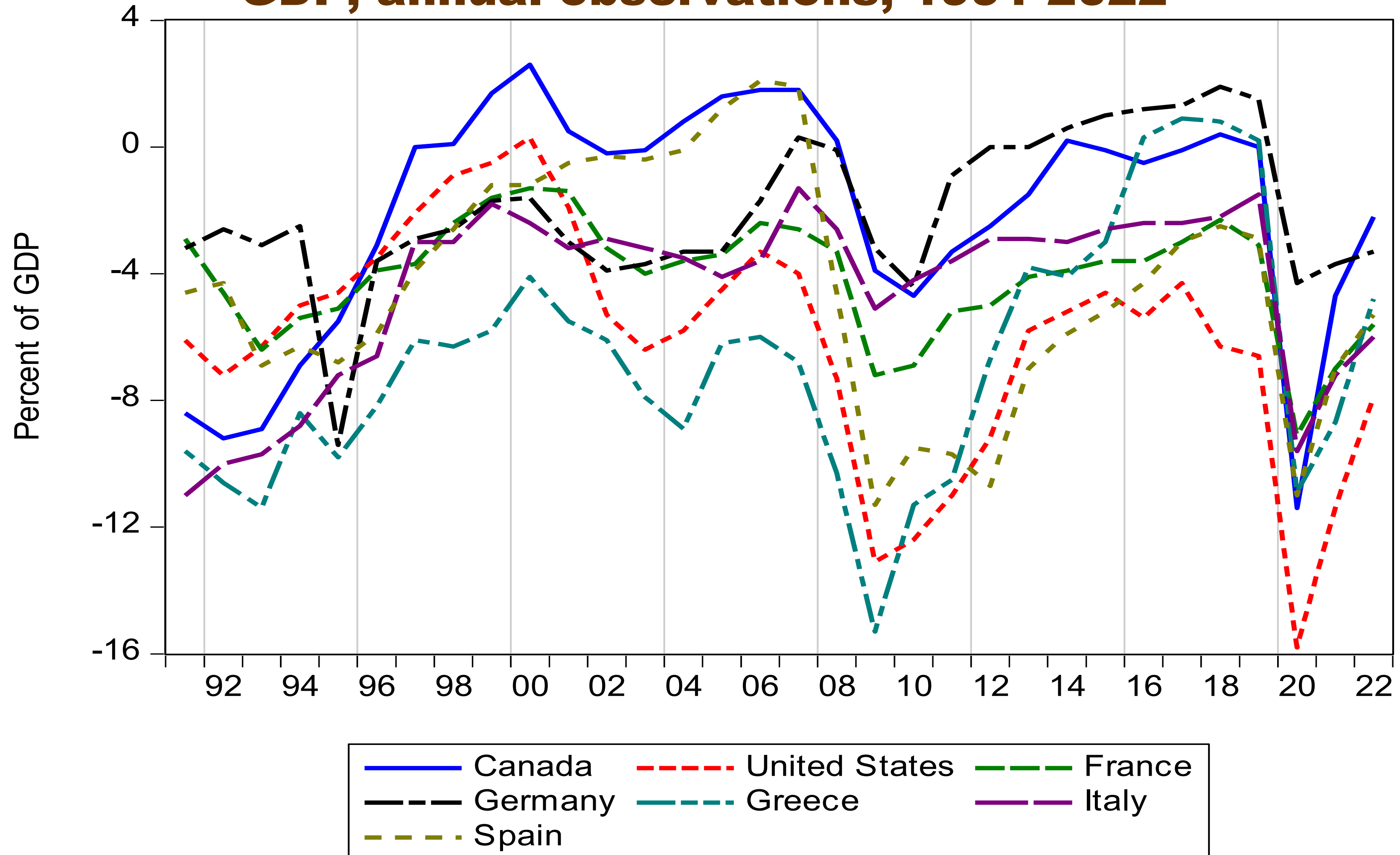


Sectoral Balances and Household Saving Rates

- In looking at these charts, what is obvious is that, when abstracting from the foreign sector current-account balance, the series are almost a mirror image of each other. A good example is the dozen Chrétien-Martin years from the mid-1990s till the GFC of 2008-2009, the government balances were consistently in the surplus.
- This drove the private sector deficit into the negative range. However, if we look at the more disaggregated series, it was the household sector that found itself systematically in the red until Covid crisis. The business sector maintained a surplus until after the GFC when it started mildly to invest more than it saved after that long period of being a net lender rather than a net borrower.
- However, what is most dramatic is what we observe when we disaggregate households by income groups (i.e., by quintiles). It's the very low-income groups who are the debtors on average, and whose rate of dissaving had barrelled downward dramatically until the Covid crisis. The bit of relief came thanks to the federal government emergency relief programme in 2020 that lifted "boats" at the lower end of the income scale, thereby reducing their rate of indebtedness.

The Importance of MMT, Deficit "Monetisation" and Quantitative Easing (QE)

- The recent historical experiences during both the Great Financial Crisis (GFC) and the Covid-19 crisis opened very wide the policy door and may well have shaped both incrementally and, one would perhaps hope, irrevocably the way modern policymakers would approach macroeconomic policy during the remaining 21st Century.
- The old worn out, yet deeply-rooted, mainstream discourse of the last half-century, which preached that governments face hard/unalterable financial budget constraints, thereby necessitating strict balanced-budget rules for a nation's public finances, has been flatly rejected during these last two crises of the 21st Century.
- In response, what has prevailed in the fiscal policy arena, especially **during the 2020-2021 period**, was the lack of public spending "inhibitions" by many policy authorities in the industrialised countries of North America and Western Europe.


Net lending (+)/borrowing (-) of all levels of governments of selected countries as a percentage of GDP, annual observations, 1991-2022
Percent of GDP
4
0
-4
-8
-12
-16
92
94
96
98
00
02
04
06
08
10
12
14
16
18
20
22
Canada
United States
France
Germany
Greece
Italy
Spain

The Importance of MMT, Deficit "Monetisation" and Quantitative Easing (QE)

- What we witnessed was the adoption and implementing internationally of what were very ambitious emergency budgetary net spending policies that, in many cases, surpassed the already historically high deficit/GDP peaks reached during the GFC.
- Indeed, after the last GFC of 2008-2009, starting in March 2020, all governments in the industrialised world pursued once again policies of running large budget deficits for stabilisation purposes during the pandemic and, yet again, without the predicted catastrophic and destabilizing effects on interest rates suggested by mainstream theory until March 2022.
- In early 2022, central banks began actively to combat inflation, through increasing doses of higher interest rates, of what was widely diagnosed at least **until the end of 2021** as a **temporary** "supply-chain" inflation phenomenon and problems of rising business mark-ups. But, with the war in Ukraine, this changed the discourse, because of fear of an inflationary wage-price "spiral" in Western countries as oil prices rose.

QE and its Supportive Role in Deficit Spending

- Over the last fifteen years, we have witnessed internationally a flood of liquidity within the banking sector resulting from central bank actions of massively purchasing government securities on the “secondary” bond market, usually referred to as quantitative easing (QE), which in the case of the Eurozone, has become normalised since early 2015. In Canada, it began only in March/April 2020 and lasted until March 2022.
- For the mainstream, QE is a pure monetary policy operation to stimulate the economy. Because of the seeming decoupling of QE from fiscal financing of public expenditures, in the case of the EMU it is seen as **not to contravene** European treaties against the **direct** central bank financing of budget deficits going back to the Maastricht Treaty.
- This is because, supposedly, central bank purchases of government securities are officially being conducted within the boundaries of the “secondary” bond market (i.e., where only previously-issued securities are bought and sold) and not on the “primary” bond market where the direct central bank buying of government securities, leading to so-called deficit “monetisation”, would presumably occur.

QE and its Supportive Role in Deficit Spending

- Some of us may not feel very comfortable with this simple binary distinction, since such a seemingly clear theoretical division can become quite blurred in practice even in the monetarily **non-sovereign** countries of the Eurozone, where it is strictly prohibited for central banks to purchase government securities on the primary bond market.
- Indeed, this whole issue of QE has kept the legal profession quite busy from 2015 until 2021 in Germany as to whether the European Central Bank (ECB) bond purchase programme contravenes European treaties on national government financing, since these treaties prohibit the ECB from engaging in the traditional notion of budgetary deficit "monetisation".
- The evidence since 2015 is quite conclusive that QE has largely saved the Eurozone from collapse by providing a financial backstop to national governments facing financing problems.

QE and its Supportive Role in Deficit Spending

- One example of this blurring might be, for instance, at Treasury auctions normally handled by sovereign national central banks, as in Canada. In most countries, primary dealers purchase securities administered by central banks on behalf of the Treasury and sell them to clients in the so-called primary market. Under QE, these securities can then be repurchased by central banks in the secondary market. The same, presumably, would occur in the Eurozone.
- For example, let us assume that, through a primary dealer, a domestic commercial bank, say, in Greece, such as the Piraeus Bank, buys a Greek government security on the “primary” market. What if, instead of being held by that commercial bank, it is then scooped up quickly, if not almost simultaneously, by the ECB through its ongoing QE asset purchases on the “secondary” securities market, especially since in most Eurozone countries, banks tend to hold a large share of their assets in such domestic securities?
- Would this not be just a magician’s “sleight of hand” to support indirectly government deficit financing? The result may be the same. Let’s look at this for a selected group of countries.

Net government securities purchased (+)/sold (-) by their respective central banks, as a percentage of total government securities in the selected countries

Country	2019	2020	2021
Canada	-8	72	67
United States*	8	52	88
France*	-6	53	64
Germany*	-242	69	104
Greece*	-8	152	78
Italy*	64	132	89
Spain*	-28	97	105

* The 2021 value was calculated with data from the first three quarters of that year.

N.B.: Canada and the United States refer to federal/central government transactions only, while all other countries include all levels of government transactions.

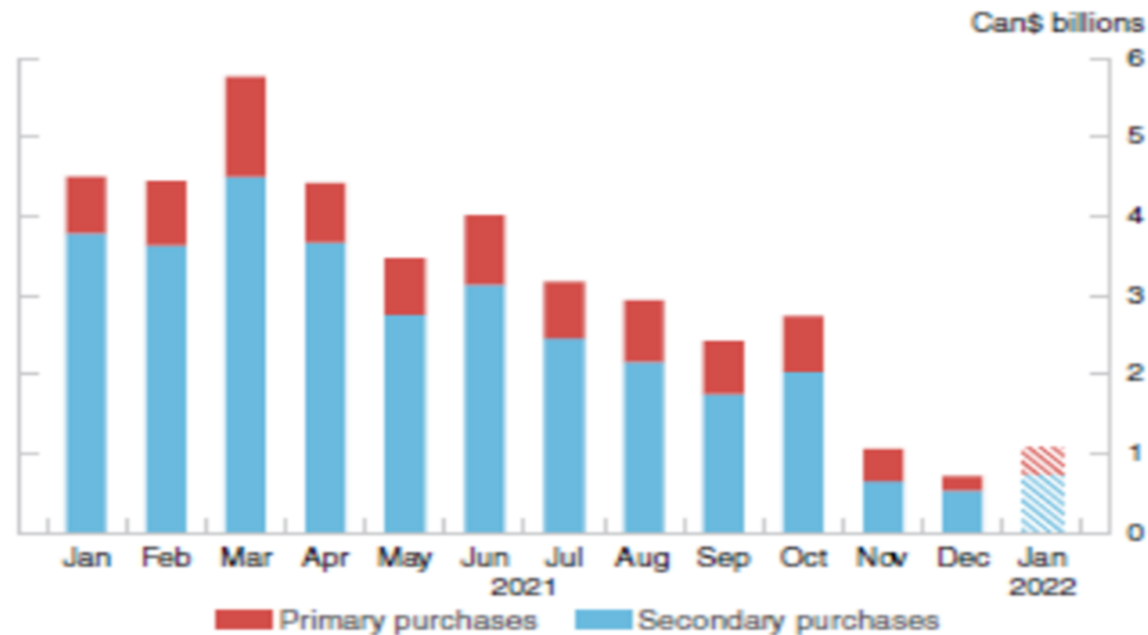
Source: International Financial Statistics (IFS), IMF, or, for Canada, it was Statistics Canada, Table 10-10-0133-01 and Table 10-10-0108-01.

The Importance of MMT, Deficit "Monetisation" and Quantitative Easing (QE)

- The Table above reveals an important dimension of what went on specifically during the pandemic by indicating the net government securities purchased by their respective central banks as a proportion of the total annual government securities regardless of whether these purchases were done on the primary or secondary markets.
- Hence, if we take Canada, before they adopted QE in 2019, the Bank of Canada sold off 8 percent of the total federal government securities that it held as a proportion of what the Canadian Treasury issued that year, thereby "downsizing" its holdings of federal government securities, which happened to be tiny in comparison to the large-scale sell-off of almost 2.5 times what in Germany the various levels of governments had been issuing in 2019.
- On the other hand, in the case of the United States, the Federal Reserve purchased some 8 percent of the newly-issued securities by the US federal government that year. Hence, from our list of countries in 2019, with the exception of Italy and the United States, central banks were reducing their stocks of previously-purchased government securities. Instead, at the beginning of the pandemic, in 2020-21, we saw a complete reversal with all central banks purchasing government securities.

“Primary” and “Secondary” Purchases of Total BofC Purchases, Monthly 2021

- This info would suggest that what MMT has been saying about central bank purchases of government securities is actually somewhat commonplace, if one looks at the significance of QE.



Concluding Remarks

- Money is not a commodity, like gold or silver, whose **scarcity** is what is critical to the well functioning of advanced market-based economies and whose resource usage would be considerable (since nature-given resources (precious metals) must be mined).
- On the contrary, money is the endogenous outcome of a creditor-debtor relation, to meet the financing needs of either the private sector or the government through the "stroke of a pen" or by punching a computer key, by a third-party (the bank) with very little physical resources used.
- Through the actions of private commercial or central banks, it leads, therefore, to endogenous monetary creation/destruction, either through the loan-making/deposit-creating capacity of commercial banks or through the actions of central banks in relation to the Treasury.

Concluding Remarks

- For real GDP growth to take place within an advanced monetary/ capitalist economy, there must be at least one sector that must go into debt, whether it is the private or the public sector. But what is a net deficit for one sector is necessarily a net surplus for another sector.
- In a monetary economy, budget deficits are the existence condition for private sector flow of saving. Hence, within a dynamic economy, government net spending is crucial for growth and capital accumulation. The two are not conflicting; they are complementary (see, especially, public investment, say, green investments in the form of a Green New Deal).
- A growth process that rests on household debt, as we have seen, is necessarily fragile, particularly because it rests on the net indebtedness of the poorest and most vulnerable of our population.

Concluding Remarks

- Budgetary deficit are not something to fear because of their supposed inflationary outcomes. The relationship is negative!

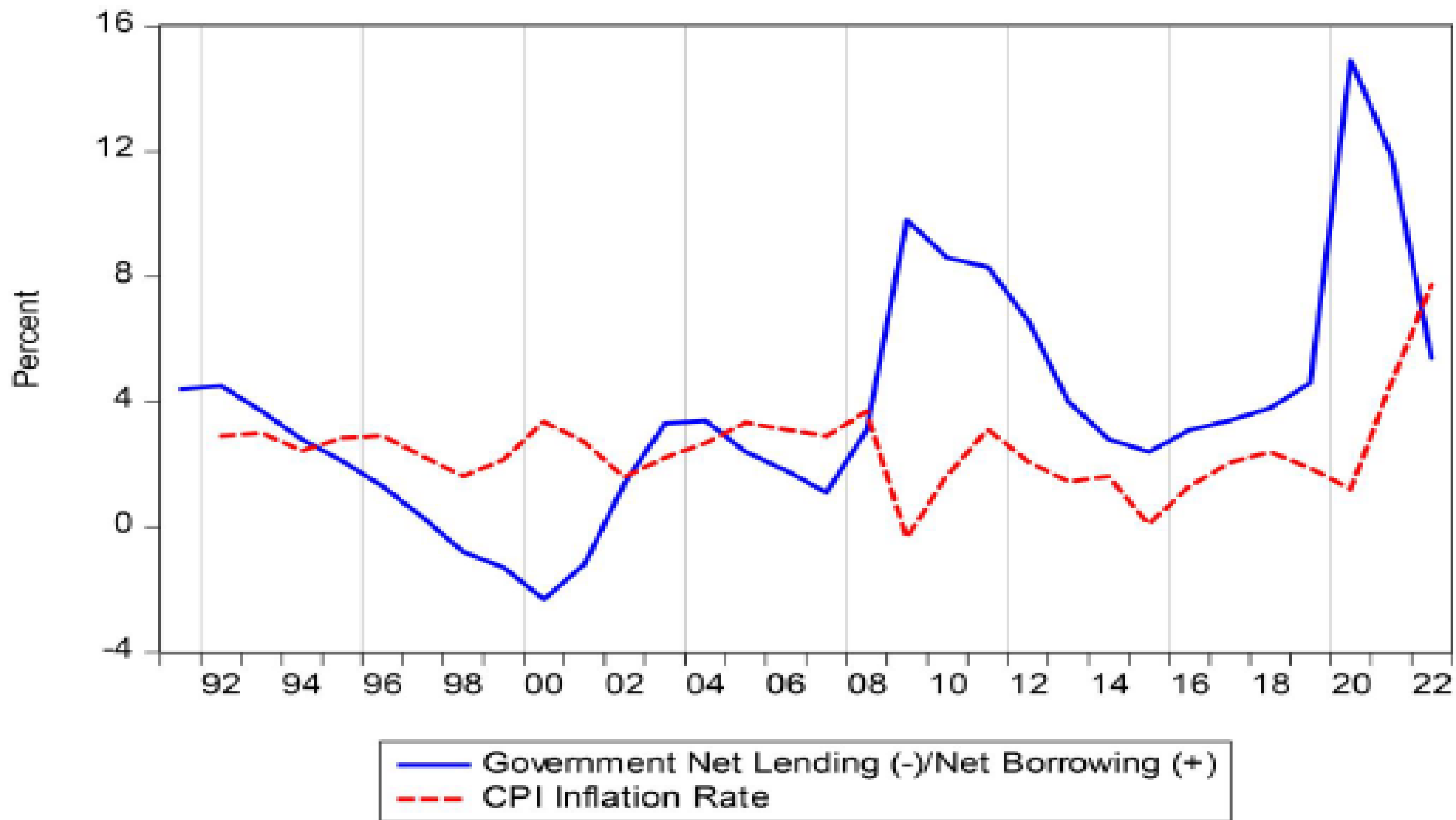


Figure 1. Government net lending (-)/borrowing (+) as a percentage of GDP and the percentage change in the Consumer Price Index (CPI) in the United States, Annual Observations, 1991–2022. Source: AMECO database for the inflation rate, while the series on fiscal balances for the United States was obtained from the Federal Reserve Bank of St. Louis (FRED) database.

Concluding Remarks

- The distinction between the so-called deficit “monetization” and QE is extremely blurred (that is, regarding the primary versus the secondary bond market).
- Moreover, deficits are not necessarily inflationary (except in a fully employed economy) regardless of how they are financed.
- Unlike countries that have their own sovereign currencies such as Canada, the UK and the US, elsewhere QE has made it possible via the “back door” to circumvent the European treatises that prevented their supranational central bank from financing net spending of governments on the so-called primary market for national government securities. The same would apply to the status of provincial governments in Canada under QE, which also loosened provincial financing of spending during the pandemic.
- The problem, however, is that QE is purely at the discretion of a central bank. In the case of the ECB, this has made the EMU system less dysfunctional (as during the Covid crisis than during the previous GFC), but it’s still a very clumsy way to set up a monetary system whose original intent was to make national governments hostages to the financial markets.

Concluding Remarks

- Unlike the Eurozone, I have always argued that most of the principal assertions of MMT, based on the Chartalist notion that a sovereign state can issue its own debt “on itself” (via its central bank without overarching physical or financial limits and without fear of bankruptcy), apply very well to a country like Canada.
- **First**: the Bank of Canada is not institutionally “independent” as is the US Fed and the Banco de México. Instead, in 1961, in Canada there was established the historical legal precedence (that has never been contested for over sixty years), which is that whenever there is a disagreement on the goal and conduct of monetary policy between the Governor of the Bank of Canada and the Federal Minister of Finance, the Governor must resign and make way for a new appointment by the elected government (this was the famous “Coyne affair”).

Concluding Remarks

- **Second:** as we have seen from our previous discussion, there are **no legal impediments** for the Bank of Canada to purchase government securities directly on the **primary market** as is the case in the Eurozone, or as is the case in Mexico where the Banco de México is prohibited by law from financing the government, nor are there Congressional "debt ceilings" paraphernalia as we find in the US that limit the amount of national debt.
- **Third:** except for a short period between 1962 and 1970 when we had adopted a fixed exchange rate (with bands), since 1950 Canada has floated its exchange rate internationally, even under Bretton Woods system. Indeed, the Bank has pursued a **pure float since 1998** and we are told that the **central bank has not intervened** in the foreign exchange markets in now over 25 years.
- These institutional features are crucial to the pursuit of MMT policy.
- On October 28, 2020, Chrystia Freeland delivered a famous speech at the *Toronto Global Forum*, which is worthy of mention here. See: https://www.canada.ca/en/department-finance/news/2020/10/address-by-the-deputy-prime-minister-and-minister-of-finance-to-the-toronto-global-forum-canadas-plan-for-a-strong-economic-recovery-from-covid-19.html

Concluding Remarks

- Here is part of Chrystia Freeland's speech:
- ***"We are Canadians. We know government spending on health care works. None of us believes it is fair or right for a worker who lost her job because of COVID-19 to be unable to feed her children, pay her bills or keep her home.***
- ***We all want our beloved local coffee shops to stay in business, even if the pandemic is eating into their already thin margins. And, bearing in mind the lengthy aftermath of the Great Recession, we understand that aggressive federal stimulus is essential to building our way out of a deep downturn.***
- ***This one is worse than 2008. It stands to reason we will need to invest more, not less.***
- ***So, the concern about pandemic spending is not about our aims or our intent. It's about capacity. Canadians are careful about the nation's finances. I know this very personally. I am from rural northern Alberta, which is not, culturally, a place much steeped in the ideas of helicopter money. And the question I hear from there, and in downtown Toronto too, is this: Can we afford it?***
- ***I am going to start with a simple answer, and then I will elaborate.***
- ***The simple answer is – yes, we can."***

Concluding Remarks

- But then she continues: "***Having said that, let me offer this important caveat. While advocating expansive fiscal policy to battle COVID-19 – and to grow our way out of the coronavirus recession – I am not among those who think Canada should have a fling with Modern Monetary Theory, which holds that deficits don't matter for a government that issues debt in its own currency.***
- ***Whether on Bay Street or Main Street, there are no blank cheques, and there are no free lunches.***
- ***Our fiscally expansive approach to fighting the coronavirus cannot and will not be infinite. It is limited and temporary. A smart and careful government – and those are two adjectives I would use to characterize our policy – will impose those limits upon itself, rather than waiting for the more brutal external restraints of international capital markets.***"
- Why is Canada's political elite so openly hostile to MMT ideas, despite the fact that our experience at the beginning of the pandemic proved that it actually worked? Why refer to the usual misleading analogy of the management by a prudent Canadian household and about the fears of the "brutal" international financial markets. What about Japan's government debt/GDP of 264% in 2022?