

## Re: Government Debt versus Private Debt

**Source:** <http://sci.tech-archive.net/Archive/sci.econ/2004-09/0405.html>

---

**From:** William F Hummel (wfhummel\_at\_comcast.net)

**Date:** 09/08/04

Date: Wed, 08 Sep 2004 22:13:19 GMT

On 8 Sep 2004 12:10:45 -0700, abacus67210@yahoo.com (abacus) wrote:

>I'm afraid that much of this is incomprehensible to me, whether due to  
>my own ignorance and obtuseness, or due to the obfuscation of the  
>writer I cannot say. However, a few points stand out to me as either  
>requiring clarification or perhaps just wrong. In the interest of  
>brevity, I'll clip the rest.

>

>> *Why the Government Borrows*

>>

>> *The public borrows from banks in order to acquire credit money to  
>> spend on investment or consumption. In contrast, the government  
>> borrows from the public only as needed to recapture its deficit  
>> spending, all of which is base money. It does so to enable the Fed to  
>> control the supply of reserves (base money) in the banking system, and  
>> thereby control the short term interest rate. The ultimate objective  
>> is to control the inflation rate over the long term.*

>

>*Silly me. I thought, just like the rest of us, the government  
>borrowed money when it needed/wanted to spend more than it had  
>'earned' (i.e. taxed).*

That's an illusion that almost everyone holds. If necessary the government could borrow from the Fed to cover its deficit spending, so the government doesn't "need" to borrow from the public. The fact that it does so is what creates the illusion.

If the government did borrow from the Fed to cover its deficit spending, the Fed itself would have to soak up (sterilize) that spending by selling the securities to the public. The net result would be the same as if the government sold the securities directly to the public. However the point remains, the government has unlimited spending power and doesn't "need" to borrow from the public. De facto, it borrows only to sterilize its own deficit spending for the reasons given.

The private sector needs the base money created through government spending in order to pay its taxes. On purely theoretical grounds,

government (deficit) spending must come before the first taxes can be paid.

- >> *Treasury securities offer an interest-earning alternative to the money*
- >> *the government spends into circulation. .... There*
- >> *will always be willing buyers of Treasury securities because the*
- >> *Treasury can pay whatever interest rate the market demands. The Fed*
- >> *strongly influences the market rates on Treasury securities through*
- >> *its selection and control of the Fed funds rate.*
- >....
- >> *Government borrowing has no net effect on the amount of base money*
- >> *since its deficit spending matches its borrowing, on average.*
- >
- >*Shouldn't that be deficit spending plus interest on money previously*
- >*borrowed matches its borrowing?*

No, the deficit is defined as spending minus tax revenues, where spending includes interest payments on the debt. When the budget is balanced, Treasury inflows equal outflows, so there is no net change in base money outstanding.

- >
- >> *The interest rates on short term Treasury securities and on credit*
- >> *money are both a function of Fed monetary policy, and not a function*
- >> *of each other. The notion that the interest rate on one directly*
- >> *affects the other is to misunderstand the causal relation.*
- >
- >*Even if it isn't a direct causal relationship, I find it difficult to*
- >*believe that no causal relationship exists. Don't those who set the*
- >*Fed fund rate base their decisions, at least in part, upon current*
- >*interest rates of both Treasury securities and credit money? Surely*
- >*they don't make such decisions without taking current rates into*
- >*consideration! And if they do, that makes the interest rates on*
- >*credit money and short term Treasury securities indirect functions of*
- >*their own and each others' previous rates.*

The Fed sets monetary policy based on many factors, the primary one being how it views inflationary pressures down the road. Other factors include the unemployment rate and aggregate demand as expressed by consumer confidence. The interest rates on credit money and T-bills are very low on the list, if there at all. I'm sure the Fed looks at those interest rates as dependent variables that simply track the Fed funds rate.

- >
- >> *Government Debt as Perpetuities*
- >>
- >> *Unfortunately conventional wisdom overlooks the fact that the debt can*
- >> *be carried indefinitely at no financial risk to either the government*
- >> *or the private sector. Individuals can become bankrupt with too much*
- >> *borrowing, but the State can never become bankrupt if it borrows in*
- >> *the same currency it issues.*
- >

>> *Nearly everyone views government debt as a future tax liability of the  
>> private sector. This is true only in theory. The unique position of  
>> the State as issuer of the monetary base, enables it to roll over its  
>> debt continuously. By electing to do so, its securities become the  
>> functional equivalent of perpetuities, i.e. bonds that have no  
>> maturity and thus are never redeemed. De facto, there is no net tax  
>> liability on perpetuities.*

>

>*Governments can, indeed, go bankrupt. Or at least, they can choose  
>not to repay loans. It's happened in other countries – usually  
>accompanied by a 'changing of the guard' so to speak. No reason it  
>can't happen here, although I dread the social upheaval that  
>inevitably accompanies such things. Governments come and go; they  
>don't exist in perpetuity. Thus neither does their debt. A defunct  
>government is no more likely to repay its debt than a dead consumer  
>is. I suppose, in a way, that supports your contention. De facto,  
>there is no net tax liability on perpetuities.*

A government that chooses not to repay loans is not an example of bankruptcy. Any examples of bankruptcy in recent decades are almost all related to the collapse of the government itself due to corruption, revolution, or war. Nothing is forever, so when we speak of perpetuities we really mean "as long as the government lasts". After that the bondholders have bigger problems to deal with.