POLICY BRIEF

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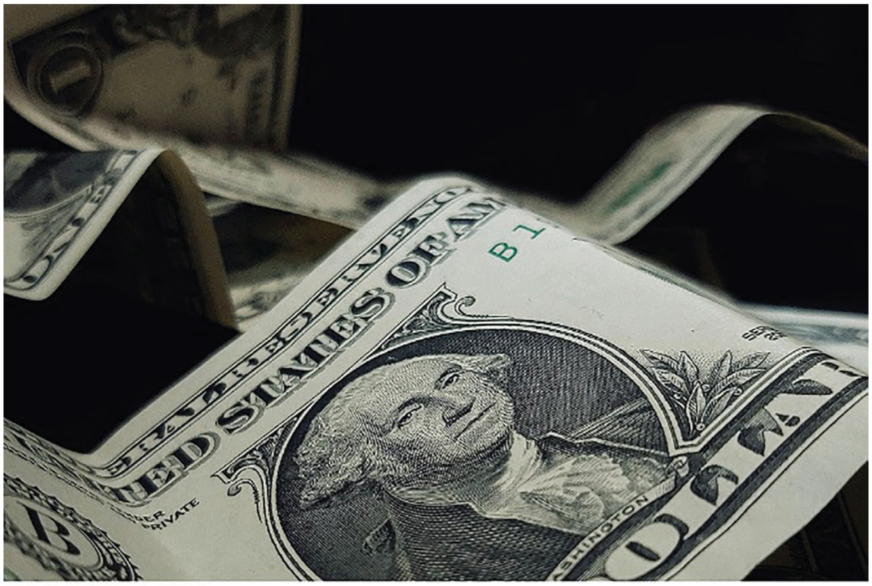
National Debt and the misleading family metaphor: A message to the economic managers and journalists



TIMIS ALEXANDRA-UNSPLASH

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A RECENT ARTICLE in the prestigious British newspaper, *The Guardian* ("Bad economics at the BBC enabled Tory austerity and its aftermath — and it knows as much," James Meadway, January 31, 2023), claimed that bad economics by the British Broadcasting Co. (BBC), the reputable British television company, enabled Tory austerity and its aftermath. A BBC internal review noted that too many journalists don't get "basic economics," with a negative effect on U.K. politics. The review refers to taxation, public spending, government borrowing, and debt output. Poor information is particularly serious when it comes to reporting on the central political issue of government debt, with some journalists apparently instinctively believing that all debt to be inherently bad. The result is that journalists very often frame policy choices, such as making cuts to spending, as if they were decisions of necessity.

Several recent articles in the Philippines have reported that the national debt reached P13.4 trillion at the end of 2022 (as reported by the Bureau of the Treasury). This represents 60.9% of GDP. Total debt is broken down into P9.21 trillion in domestic debt and P4.21 trillion in external debt. The tone of these articles also reflects a negative view of public debt. The government is aiming at a debt-to-GDP ratio of less than 60% by 2025 and 51.1% by 2028, seemingly coinciding with what some commentators say that if the Philippines' debt stays above 60% of GDP, the country might be subject to a credit downgrade, which would increase the cost of additional borrowing. Hence the need to reduce/improve the debt-to-GDP ratio to below the 60% international threshold.

The reality of the so-called national debt is very different from how it is reported and assessed on TV and newspapers, and even by some economists and members of the government. The review of the BBC's reporting on government spending and debt is welcome because it serves as an example to other countries.

Government debt manifests itself as pieces of paper that are freely purchased by the private sector. It is fundamental to differentiate between debt in domestic currency and debt in foreign currency. The first one does not pose a solvency problem (unless the government willingly chooses not to service it), whereas the second one could be a headache for developing countries, as these need to earn foreign currency by exporting or by attracting foreign investment. There are several fundamental misunderstandings about how governments spend and what debt is, that are worth clarifying.

Governments do not have currency (dollars, pesos, rupees, euros, pounds….) and do not print it. They spend by data entry on their own spreadsheet and by crediting bank accounts. And even if they spend using cash, it would be the same thing: data entry but written on a piece of paper rather than entered into a spreadsheet. When governments spend, the funds do not come from anywhere. It is fiat money.

Governments, when they spend, credit bank accounts and private banks' reserves. Reserves are just a form of government currency used by banks to make payments to one another and to the government. If you later want cash, your bank lets you withdraw it. It uses its vault cash. And if it does not have enough, it calls the Central Bank, which delivers paper money and debits the bank's reserves.

The U.S. government has run deficits for over 200 years. Can your family do it? Do you have unlimited power to credit accounts electronically? The household analogy most often used is totally wrong. A sovereign government does not face solvency risk in domestic currency: Governments cannot go broke, and their checks do not bounce. Yes, many impose artificial constraints on themselves (people should know they are self-imposed). This does not mean that they are financially constrained like you and me. The fact that governments are not financially constrained like you and me (and hence the standard idea of a government budget constraint should also be reconsidered) does not mean they can spend at will and on anything they want to. The limit is inflation, not the fallacy "the government does not have money."

The standard argument is that to sustain government spending, the government must issue securities. The reality is that securities (debt) are issued as a result of unwarranted cash balances that appear as excess reserves in the banking system, that is, excess liquidity in the banking system. Reserves have to be drained because, otherwise, the interest rate set by the Central Bank would go down to zero.

This means that, contrary to what is often preached, government deficits put downward pressure on the Central Bank's overnight interest rate. Excess reserves are dried up by issuing bonds. This is what the Central Bank and Treasury effectively do, although they think they are "financing" the deficit. Naturally, the "crowding out" argument (of the private sector) is also incorrect, as the latter is based on the misleading idea that there is a fixed pool of money in the market and that public and private sectors fight for it in such a way that government deficits lead to increases in interest rates. This cannot be further from the truth. In fact, it is the opposite.

Note that a government deficit means that government spending (by crediting accounts, not by using taxes) is higher than tax collection from the public at large. Why is this necessarily bad? A surplus, on the other hand, takes away spending power from consumers. Why would anybody want fiscal surpluses? Does this mean a more efficient government? Are surpluses saved to pay for things "tomorrow"? Budget surpluses are, most often, deflationary (yes, at times, a surplus might be needed to cool the economy). I insist that this does not imply that the government should spend as if there is no tomorrow. It simply means that government spending should be reconsidered and presented as what it is: a transfer to the private sector that plays an important role in the economy, in particular, in that of a developing country.

National debt is the sum of past government deficits (minus cancellations). As noted above, government debt is, in practice, pieces of paper (IOUs) where the private sector willingly parks its excess liquidity. Why? Because the government always pays back (in its own currency). How? Naturally, by crediting accounts; not to mention that states don't tend to retire or die or pay off their debts entirely. And naturally, government spending at any point in time does not affect future generations, no matter how many Treasury securities are outstanding. Government debt is wealth in the hands of the private sector; interest payments are payments to the generation that receives them; and the government services bonds by crediting bank accounts.

All Treasury securities do is offset operating factors at the Central Bank—nothing to do with saving and investment. A deficit exactly equals the total net increase in the holdings of financial assets of the non-government sector (business and households, residents and non-residents). Deficits add to national savings (of the non-government sector): (i) Government sells P100 Treasuries (which becomes the wealth of the private sector); (ii) Government spends the P100 it received from the selling of Treasuries. The result? The non-government sector now has P100 in bank accounts and P100 in new securities. Surpluses, instead, subtract savings as they are a net decrease in non-government savings of financial assets. An economy cannot have a budget surplus with private savings increasing (including non-resident savings of the country's financial assets). Watch out for reductions in budget deficits that will reduce the injection into the economy and, worse, surpluses: households will have to sell securities so that they can pay for their taxes. Their net financial assets and savings go down by the amount of the surplus.

Reporting on government spending and debt through the family metaphor is very misleading. Indeed, the conceptual leap from government financing to household borrowing distorts the truth. Although it is important to monitor debt, it is even more important to understand what the government spends on and how this benefits the economy. That some of this spending might be labeled "inefficient" does not imply that debt has to be controlled so as not to go over 60% of GDP. The nation's economic managers need to use government spending to achieve the national goals. This requires awareness of the fact that issuing securities (debt) is an operation to offset operating factors at the Central Bank, not borrowing as commonly discussed (i.e., a matter of necessity). The 60% debt threshold is an invention. It might be true, though, that rating agencies could downgrade the Philippines. This is unfortunate (poor understanding) as it is what would harm the country.

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