Centre of Full Employment and Equity

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The divisions among progressive macroeconomists – Part 1

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The recent Commonwealth Treasury Debt Management Review highlights the damaging divide among "progressive economists" in Australia when it comes to macroeconomic analysis. This fracture is greater than the things that bind us and helps the neo-liberal orthodoxy to defend their appalling economic record.

First, let us establish common ground. Progressives should agree on the need to present a strong alternative economic stance in the face of neo-liberal dominance. This is especially crucial given that both major political parties are now advocating flawed economic positions and are virtually indistinguishable. There is no effective Federal opposition to challenge the dominant paradigm. The Australian Labor Party (ALP) now sees fiscal policy as a contest over which party can generate the biggest fiscal surplus. They never consider that sensible macroeconomic management is rather measured by the role that deficit spending has in maintaining full employment. When federal spending increases, prior to the election, drove the budget into deficit for the first time in 4 years, the ALP attacked it as fiscal excess. But the deficit actually insulated the economy to some extent from the subdued world economic climate. It was a wonderful opportunity for the ALP to recast the fiscal landscape and they failed dismally.

Both major parties have abandoned the goal of full employment and now pursue the diminished goal of full employability. The government no longer ensures that there are enough jobs for all those willing to work but focuses, instead, on getting individuals 'work ready', should there be jobs available. The ALP follows lock step. By accepting the neo-liberal definition of full employment, as consistent with high levels of 'natural rate', Australian policy-makers have jettisoned essential and sustaining conditions for a social democracy.

One also hopes that progressives can agree on what causes the mass unemployment that has endured since 1975. When the non-government sector spends less than their income, output will go unsold leading to declining production and employment unless there is an appropriate increase in net government spending. Wage cuts (money or real) *per* se cannot solve the problem, unless they somehow eliminate the desire of the private sector to net save, and thereby increase spending. The government is the only entity that can simultaneously accommodate any net desire to save (by providing the non-government sector with net financial assets) and eliminate unemployment. That is the role of deficit spending.

The Australian economy has maintained growth in the 1990s with federal surpluses only because the non-government sector has increasing deficits. This growth strategy is unsustainable because the deteriorating balance sheets of the private sector will finally unwind leading to a slow-down in real activity accentuated by the fiscal drag.

At this point the wheels fall off …

Advocating persistent deficits is not a popular position in 2003. A progressive economist has to advocate deficits given our external sector position if they are to also argue for full employment (unemployment below 2 per cent). But many progressives make it difficult for themselves because they support the neo-liberal myth that deficits have to be "financed".

In fact, there are no financial constraints on federal government spending. The analogy between household and government budgets is false. A household, the user of the currency, must finance its spending, *ex ante*. But, there is no sense that the government, as the issuer of the currency, can be financially constrained in its spending.

Neo-liberals introduce the government budget constraint (GBC) to demonstrate that government spending can be "financed" by taxation, debt issuance and/or printing money. A deficit is thus "financed" by debt and/or printing money. The former is (wrongly) alleged to crowd-out private sector spending by pushing up interest rates, while the latter is dismissed as inflationary. This builds their case for budget surpluses. Most progressives appear comfortable with using deficit spending to increase economic activity, but continue to couch their recommendations in conservative logic bounded by "appropriate" movements in the debt to GDP ratio and balances of taxation and debt to match the maturity of impacts of government spending. The GBC is actually only an *ex post* accounting statement with no particular import.

Two submissions were made to the Treasury Review by progressive economists (http://debtreview.treasury.gov.au/content/home.asp). The Evatt Foundation submission, based on papers by Tony Aspromourgos and Frank Stilwell was the polar opposite to that provided by the Centre of Full Employment and Equity (CofFEE) (written by myself and Warren Mosler). The other Review submissions were largely self-serving pleadings for continued government assistance from the major players in the Commonwealth Government Securities (CGS) market. Why would the Evatt Submission reach the same conclusion as the financial markets?

The equations in the Evatt Submission (page 10) are derived from the GBC model. Stilwell also operates within this framework saying that "Governments can finance their expenditure either by taxes or by borrowing … [and with political constraints on taxation] … reduced government borrowing means lower capital expenditure. So the deterioration in public infrastructure – in the quality of 'public goods' in general – is a direct consequence of the commitment to debt reduction" (6-7).

Immediately, the argument then becomes one of "why isn't there more debt issuance" as opposed to "why aren't there budget deficits". The decline in the quantity (quality) of public goods is a direct consequence of inadequate levels of government spending and has nothing at all to do with the extent of CGS issuance. To link the two essentially independent functions is to constrain the macroeconomic analysis within an orthodox paradigm.

Stilwell (Evatt Submission, page 6) says "Of course, government borrowing involves a cost – the interest payments on government bonds, for example … But whether the interest constitutes a 'burden' depends upon how it compares with the social benefits arising from the government spending. As in the case of the carpenter's personal debt, the interest payments are not a net burden if the future income-generating capacity is enhanced." This is the old Keynesian defense of the unnecessary and is almost apologetic in nature. It is a sort of "well if it is good for the household then it must be good for government". In doing so we are left with the false neo-liberal analogy between the private agent (user of the currency) and the government (issuer of the currency). The factors that lead a private investor to borrow are varied but all of them are irrelevant for the government spending decision. If there is a social "rate of return" for a particular item of government spending then it will accrue whether there is debt issued or not. To say that some public debt is wise and some is unwise (Evatt Submission, page 6) is to fundamentally misconstrue the purpose of the debt issuance – which is to repeat, drain excess liquidity to allow monetary policy to work.

The "financing" trichotomy in the GBC is not a robust description of the way in which government spending and financial markets work. Government spends by crediting an account at a Reserve Bank of Australia (RBA) member bank. This process cannot be revenue constrained (Government cheques don't bounce). Governments don't spend by "printing money". Taxation consists of debiting an account at a RBA member bank. While the funds debited are 'accounted for' they don't actually 'go anywhere' nor 'accumulate'.

If there are no financial constraints on government spending, then what roles do taxation and debt issuance serve? I present only a brief and relatively loose argument here (see references at the end for further analysis).

On taxation, the federal government is the sole provider of *fiat currency* or money. Tax liabilities must be discharged using this currency and federal spending provides the private sector with the currency they need to pay their taxes and to net save. As government spending precedes tax payments it logically cannot be financed by taxes. Taxation rather sets up the motive for the private sector to transfer goods and services to the public sector. It can play other roles (resource re-allocation and redistribution). Further, if private sector desires to net save are to be fulfilled then aggregate government spending must exceed taxation (a budget deficit). Budget surpluses squeeze the desires of the private sector to hold financial assets, net save and pay taxes and ultimately lead to mass unemployment.

What about debt? Neo-liberals claim that budget deficits are bad because they allegedly push interest rates up and thus "crowd out" private spending that relies on borrowed funds. This “crowding out” argument fundamentally misconstrues the way the banking system operates to set interest rates.

The RBA conducts monetary policy by setting and maintaining a target (cash) interest rate. Strong private demand for money (relative to supply) places upward pressure on interest rates and the RBA has to supply funds to the private banking system (buying government bonds from private holders) in order to keep the cash rate on target range. The RBA sells bonds when private demand for money is less than supply. The downward pressure on rates is avoided by withdrawing “excess money” from the banking system. That is how monetary policy works.

The excess funds that a budget deficit promotes place downward pressure on interest rates. Government debt is issued to maintain existing rates, which would otherwise fall, and is purchased by the private sector to earn a market yield on their reserve holdings. Government debt is not issued to finance the spending.

Without debt issuance, individuals may adjust their portfolios if they do not desire to hold the extra cash in the system by increasing consumption spending. Aspromourgos (2002) suggests that this will be realised as inflation. Why? It just means that full employment can be maintained with lower deficits. That seems good. The relationship between monetary growth and the price level is complex and depends on the state of aggregate supply. In times of deficient-demand, firms have excess capacity and respond to increased demand by increasing production and employment rather than increasing prices. The 1990s expansion demonstrated that.

The CGS Market Debate and CofFEE’s submission

The Treasury Debt Review followed concern that the CGS market was shrinking as the government applied their surpluses to retiring debt. The submissions to the Treasury CGS Review were largely framed in terms of a ‘public good’ argument. The CofFEE submission rejected this approach and concluded that the CGS market has no particular benefits to offer in terms of the achievement of desirable macroeconomic policy goals (like full employment and price stability) and the prosperity of the Australian people. While financial system stability is a public good, and is the legitimate responsibility of government, its realisation and maintenance does not require a viable CGS market. The Evatt Submission (page 2) is heavily dependent on the erroneous argument that debt is essential to finance deficits and is thus totally at odds with the CofFEE approach. They suggest that there is a useful role for positive levels of CGS. We emphatically reject that conclusion.

In fact, the case for maintaining CGS and derivatives markets is more accurately couched as special pleading by an industry sector for public assistance in the form of risk-free CGS for investors as well as opportunities for trading profits, commissions, management fees, and consulting service and research fees. It is ironic that the arguments advanced by financial sector interests are inconsistent with the rhetoric forthcoming from the same sector about the urgency for less government intervention, more privatisation (for example, Telstra), more welfare cutbacks, and the deregulation of markets in general, including various utilities and labour markets. CGS issuance is a form of government price level intervention in interest rate markets and there is sufficient evidence to show that financial markets will function well enough without this price support.

Progressives who argue differently have to face the fact that CGS issuance actually helps unproductive speculators manage their risk more easily and thus supports and encourages speculation, rather than real investment behaviour. Is that appropriate progressive public policy? They also have to show why it is useful for the non-government sector to have access to government annuities rather than be directing real investment via privately-issued corporate debt, as an example?

CofFEE shows that the primary role of CGS is to support the term structure of interest rates rather than to fund government expenditure. With flexible exchange rates there is no reason for CGS issuance. The RBA can loan banks any needed funds, including actual cash, at any interest rate, and require any other bank assets as collateral with no aberrant effect on the monetary system. Put bluntly, there is no compelling macroeconomic reason why risk and return decisions by private maximising agents should be 'further protected' by retreat to a market distorting government annuity.

Once we accept that government spending is not financially constrained and appreciate that CGS issuance is about monetary policy we can see that the Evatt Submission's talk about an optimal debt ratio is both irrelevant to achieving full employment and damaging to the progressive cause. An economy can easily sustain zero public debt issuance without aberrant economic consequences.

The important point that must bind progressive economists is that the government must net spend to sustain aggregate demand levels consistent with a full employment objective.

It is clear that more discussion has to occur between progressive macroeconomists to search for ways in which our differences can be resolved. In general, I believe the answer lies in rejecting the orthodox paradigm outright and gainer a sharper appreciation of how financial markets actually work. It is very different to the way that orthodox macroeconomics textbooks pretend they work.

In Part 2, the divisions among progressive economists on employment policy will be discussed.

Further reading

Aspromourgos, T. (2002) 'Comments on Fiscal Policy and the Job Guarantee', *Australian Journal of Labour Economics*, 5(2), 261-264.

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