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Monetizing the Debt

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Governments can finance deficit spending by issuing debt or printing money. In most countries, a government-created central bank controls the money supply—in the United States, this task belongs to the Federal Reserve System. This means that the U.S. Treasury has only one option for financing deficit spending—issuing debt.[1] Of course, the government could still finance deficit spending if the central bank created money by purchasing government debt. For example, assume the Fed purchased government securities. The Treasury would pay interest on the government securities to the Fed and the Fed could then return the interest income (net of its operational expenses) to the Treasury. The Fed would effectively be financing deficit spending by "printing" money. It would simply be a two-step process: The government would sell debt to the public and the Fed would exchange the public's holdings of government debt for money. Many analysts call this two-step process "monetizing the debt."[2] I argue that this definition of monetizing the debt is narrow and uninteresting. I also contend that from a more interesting and economically relevant perspective (discussed below), the Fed need not purchase Treasury securities to "monetize government debt." Finally, I suggest that monetizing the debt depends crucially on the purpose of the Fed's (or any central bank's) actions.

A more interesting and economically relevant definition of "monetizing the debt" is based on the Fed's motivation rather than its actions.

The idea that the Fed monetizes government debt by the simple act of exchanging money for government debt is too narrow and uninteresting because the Fed conducts monetary policy primarily through open market operations—buying and selling securities—most often government securities. When the Fed purchases securities the stock of high-powered money (also known as the monetary base) increases.[3] When it sells securities the monetary base decreases. If "monetizing the debt" is defined as the act of converting government debt to money, there would be no reason to ask, "Has the Fed monetized the debt?" The answer would be simple: "Yes, every time it purchases government securities." Moreover, the goal of the Fed, and most other central banks, is to promote maximum sustainable economic growth and price stability. In the process of achieving this goal, the money supply expands over time with the needs of a growing economy. While the Fed's actions to increase the supply of money over time would, in effect, be financing deficit spending by "printing" money, this would not be the purpose of the Fed's actions and, hence, critics would be wrong to claim that the Fed has monetized the debt.

I suggest that an economically meaningful definition of "monetizing the debt" must be based on the Fed's motive for increasing the money supply. For example, during World War II the Fed had an explicit agreement with the Treasury to stabilize the Treasury's cost of war finance. Consequently, the Fed purchased large quantities of government debt to keep interest rates from rising. This created a large increase in the monetary base and the money supply. After the war concerns arose that the Fed was continuing its policy of helping the Treasury finance the large war debt by attempting to keep interest rates low. This led to an accord between the Federal Reserve and U.S. Treasury on March 4, 1951, that established the Fed's independence.[4] In effect, the accord gave the Fed the freedom to control the money supply to achieve its monetary policy goals rather than aid the Treasury with its debt-financing effort.

An example may help differentiate the motivation aspect versus actions taken by the Fed. If the Fed purchases government debt solely to achieve its objectives of price stability and maximum sustainable economic growth, it is not monetizing the debt. In this case, the Fed's actions are designed not to reduce the amount of interest-bearing government debt held by the public, but rather to provide an appropriate growth in the money stock consistent with price stability and maximum economic growth. While more economically

meaningful, this definition is difficult to make operational for two reasons: uncertainty regarding the Fed's primary motivation and timing of the intervention.

First, it is difficult to determine whether debt purchases are solely driven by the Fed's policy. Second, the Fed increases the monetary base whenever it purchases any asset—not only when it purchases government debt. For example, the Fed has completed its purchase of $1.25 trillion in mortgage-backed securities (MBS) in an effort to support the sagging mortgage market. These purchases have increased the monetary base just as if the Fed had purchased an equivalent amount of government securities. Whenever the Fed purchases any debt, it increases the total supply of credit in the credit market by the amount of the purchase. For example, if the Fed is holding $1.25 trillion in MBS formerly held by the private sector, the credit previously supplied to the MBS market by the private sector is available to purchase government debt. Hence, as long as the amount of credit supplied by the private sector is not affected by the Fed's actions, the implications of the Fed's actions for federal finance will be much the same as if the Fed had purchased government securities—a central bank does not have to purchase government securities to *monetize debt*.

Since March 2009 the Fed has increased its holding of MBS, federal agency debt, and long-term government securities by more than $1.5 trillion for the express purpose of helping the mortgage market and flattening the yield curve to mitigate the effects of the financial crisis. At the same time, the government has been running an unprecedented fiscal deficit. So far, banks have been content to hold the reserves created by these actions. If banks were to lend these reserves, there would be a massive increase in monetary aggregates like M1 and M2. The Fed has expressed a desire to neutralize the potential effect of its massive acquisition of securities on the monetary aggregates by paying interest on bank excess reserves and/or by offering banks term deposits that bear a market rate of interest. Such a scenario would mean that much of the interest income generated by the Fed holding these assets would be paid to banks rather than rebated to the Treasury. From the point of view of Treasury finance, the effect would be much the same as if the private sector (specifically, banks) were holding the debt. Indeed, if the interest paid by the Fed exactly equaled its interest income, the effect would be the same as if banks were holding the debt. The Fed would be merely allocating credit by purchasing securities from the private sector and paying the interest income from these securities to banks.

The only effective way to determine whether the Fed (or any central bank) has monetized debt is to compare its performance relative to its stated objectives. Many central banks have adopted a numerical inflation target. If inflation is running above the target when the government is faced with a debt-financing issue, one might suspect that the central bank is monetizing the debt. The Fed has not adopted a specific numerical inflation target, which makes it more difficult to determine whether its actions are purely motivated by its policy objective. In general, the more explicated a central bank is about its policy objectives, the easier it is to determine whether it is monetizing the debt. ■

[1] The Fed is forbidden by law to purchase government securities directly from the government. The government first sells securities to the private sector and the Fed then purchases securities from the private sector, specifically, government securities dealers.

[2] For a number of such definitions, perform a Google search for "monetizing the debt."

[3] The monetary base (currency plus reserves) is called "high-powered money" because each dollar of reserves can support multiple dollars of bank deposits that are included in various monetary aggregates like M1and M2.

[4] The statement read "The Treasury and the Federal Reserve System have reached a full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize the monetization of the public debt" (Federal Open Market Committee Minutes, March 3, 1951; cited at www.richmondfed.org/publications/research/economic_quarterly/2001/winter/pdf/hetzel.pdf).

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Views expressed do not necessarily reflect official positions of the Federal Reserve System.