Private and Public Debt in Australia

What is the difference, and does it matter?

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The views expressed in this presentation are my own, and do not necessarily represent or reflect the views of any school of thought or the position of any organisation.

However I believe that these views are consistent with the state theory of money, the theory of functional finance, monetary circuit theory, and modern monetary theory.

'The game of policy making is rigged. The Prince is constrained by the theory of his intellectuals.'

'Lack of understanding of the monetary system has been the worst enemy of the progressive agenda.'

Difference between debt and liability

A liability is a legally binding obligation relating to payment to another entity.

A debt is an amount owed for funds borrowed. The lender agrees to lend funds to the borrower upon a promise by the borrower to pay interest on the debt, usually with interest to be paid at regular intervals. More generally, the interest to be paid has a servicing schedule, in other words there is a payment timeline.

Debt is a subset of liability.

What is the nature of a bank deposit?

A deposit within a retail bank account can be either a **demand deposit** (transaction account) or **term deposit** (term account).

A term deposit can be regarded as a borrowing by the bank from a bank customer, and therefore it is a **debt of the bank**. There is a rigid time schedule for the payment of interest and repayment of principal.

A demand deposit is a **contingent liability of the bank**, because there is no time schedule for the bank's obligation to pay the depositor on demand.

Private debt

Private debt, as incurred by individuals, households and businesses, is mainly created by banking institutions and finance companies. At the beginning of 2022 the ratio of Australian net private debt to GDP was about 190%.

By far the largest part of that debt is home mortgages (62.5% of private debt) followed by commercial loans (32.7%).

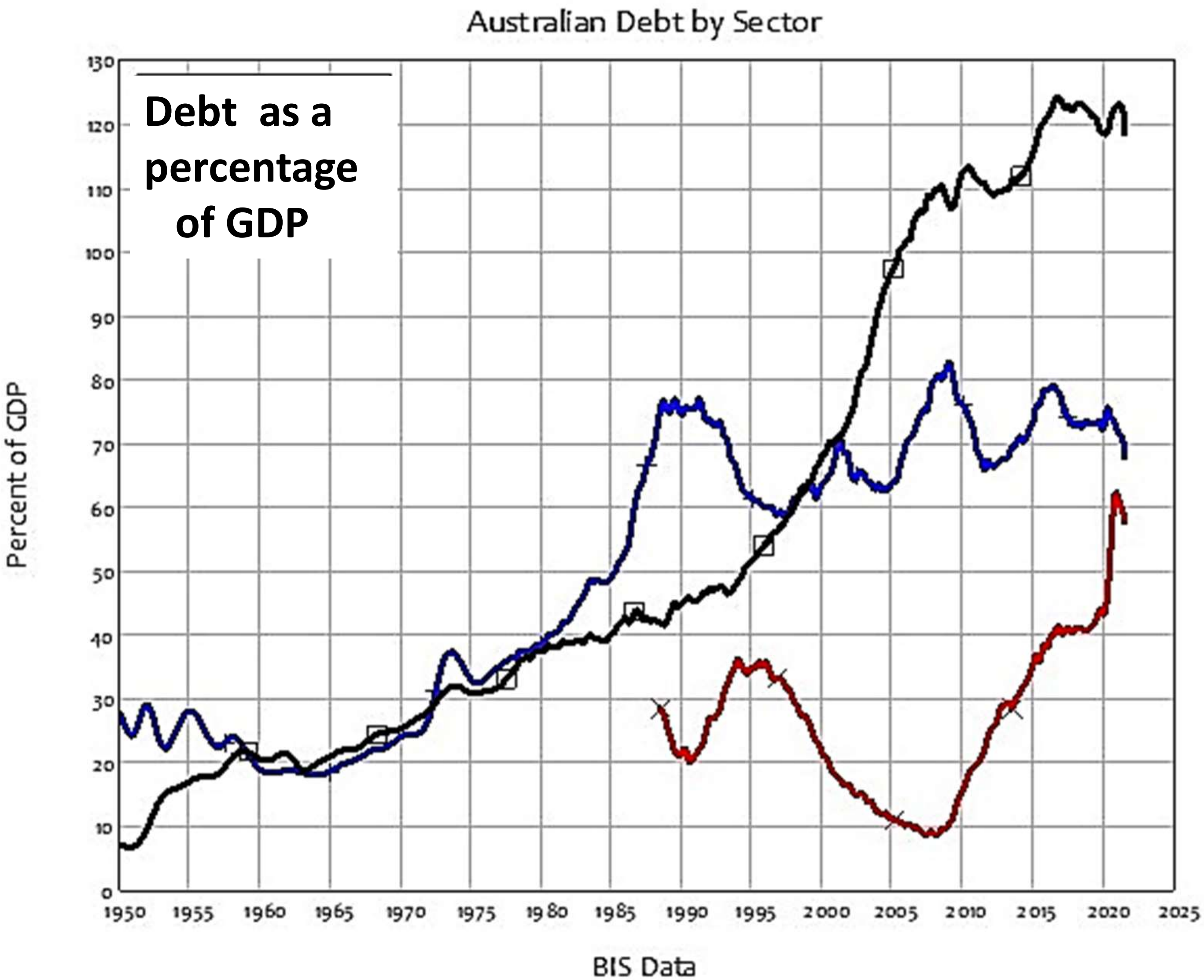
Banks create new money when they lend to non-banks

Lord Mervyn King, former Governor of the Bank of England

Public (government) debt

By comparison with private sector debt, federal government net debt in early 2022 amounted to about 35% of GDP, and state government net debt was about 13% of GDP.

Federal government debt is primarily comprised of federal Treasury securities (mainly tradeable bonds) issued to the private sector, traditionally in association with deficit spending.



2022 debt aggregates

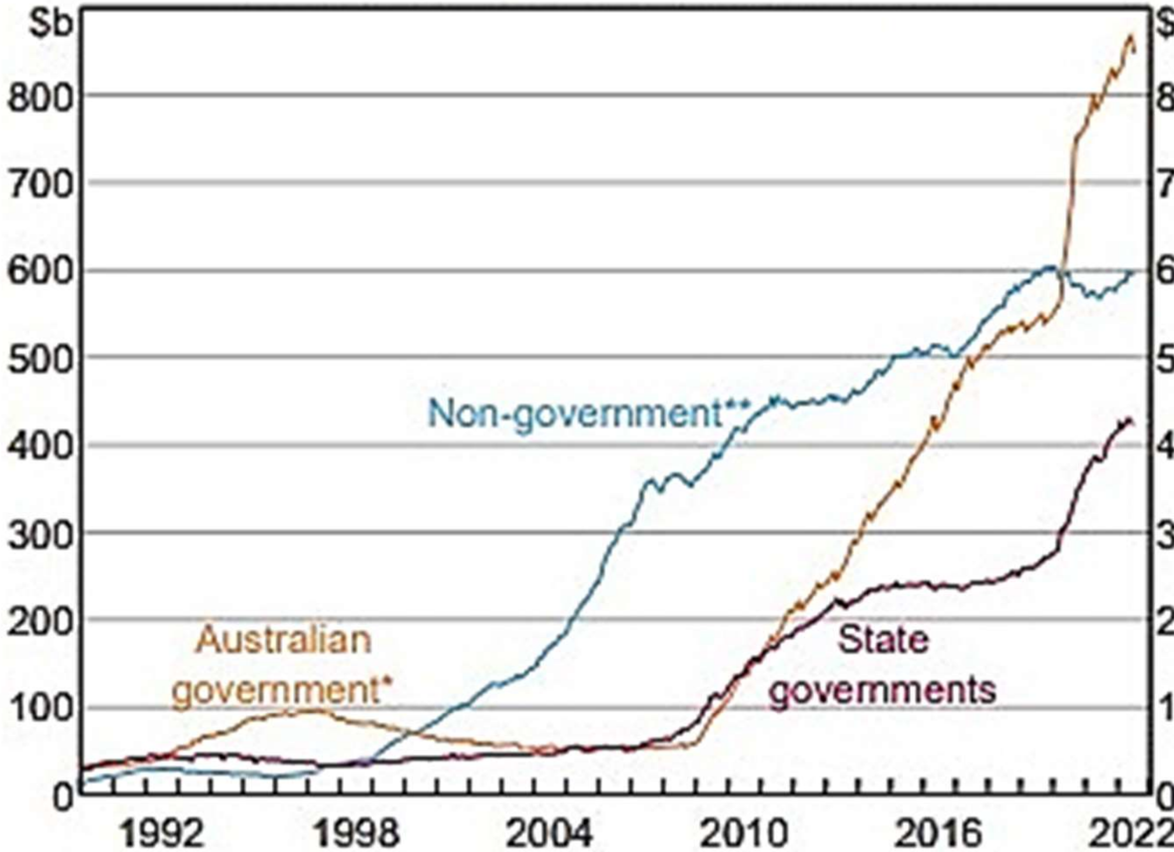
Household 118%

Corporate 68%

Public 58%

- **(a) Federal 35%**
- **(b) State 13%**
- **(c) Municipal 10%**

Bonds on Issue in Australia



* Excludes bonds purchased by the Australian Government.

** Excludes ADIs' self-securitisations, includes government-guaranteed bonds.

Sources: ABS; AOFM; Bloomberg; KangaNews; Private Placement Monitor; RBA; State Treasury Corporations

Is public debt inflationary?

There is no necessary connection between public debt and inflation. Securities are issued as a part of deficit financing.

Federal deficit spending is a fiscal operation which currently entails borrowing from either a bank or non-bank, and spending the same volume of money back into the economy. Using a broad definition of money (and also of the monetary base), both forms of federal deficit spending result in the creation of net financial assets for the non-bank private sector.

With deficit spending by lower levels of government, any money received from the debt issue is saved and used as revenue, and there is no overall change in the volume of financial assets available to the non-bank private sector.

Monetarists and neoclassical economists think that net financial assets created by federal spending are inherently inflationary because they believe inflation is caused by money creation, rather than supply issues.

Routes to deficit spending

Let's look at federal deficit spending in a little more detail. The two routes to the creation of net financial assets entail:

Purchase of securities by a bank. The bank pays for the securities using exchange settlement reserves, which are destroyed at the time of payment. The federal government spends the same volume of money into the non-bank private sector, and the RBA supports this with the same volume of new reserves. The net result is that each payee from the spending receives a new asset consisting of bank deposit money ("credit") which is unmatched by any liability.

Purchase of securities by a non-bank. The non-bank pays from a bank account. Both reserves and credit are destroyed at the time of payment, and the government spends the same volume of both credit and reserves. The net financial asset in this case is the purchased security.

Net money supply

The money supply is the conjunction of the following aggregates:

(a) Deposits in banking institutions by the non-bank private sector,

(b) Physical currency held by the non-bank private sector,

(c) Other money equivalents that can be easily converted to physical currency (e.g. traveler's cheques of non-bank issuers).

The net money supply is the conjunction of the following aggregates:

(a) Treasury securities on issue to the non-bank private sector, and

(b) All other financial assets owned by the non-bank private sector which are not matched by liabilities of that sector.

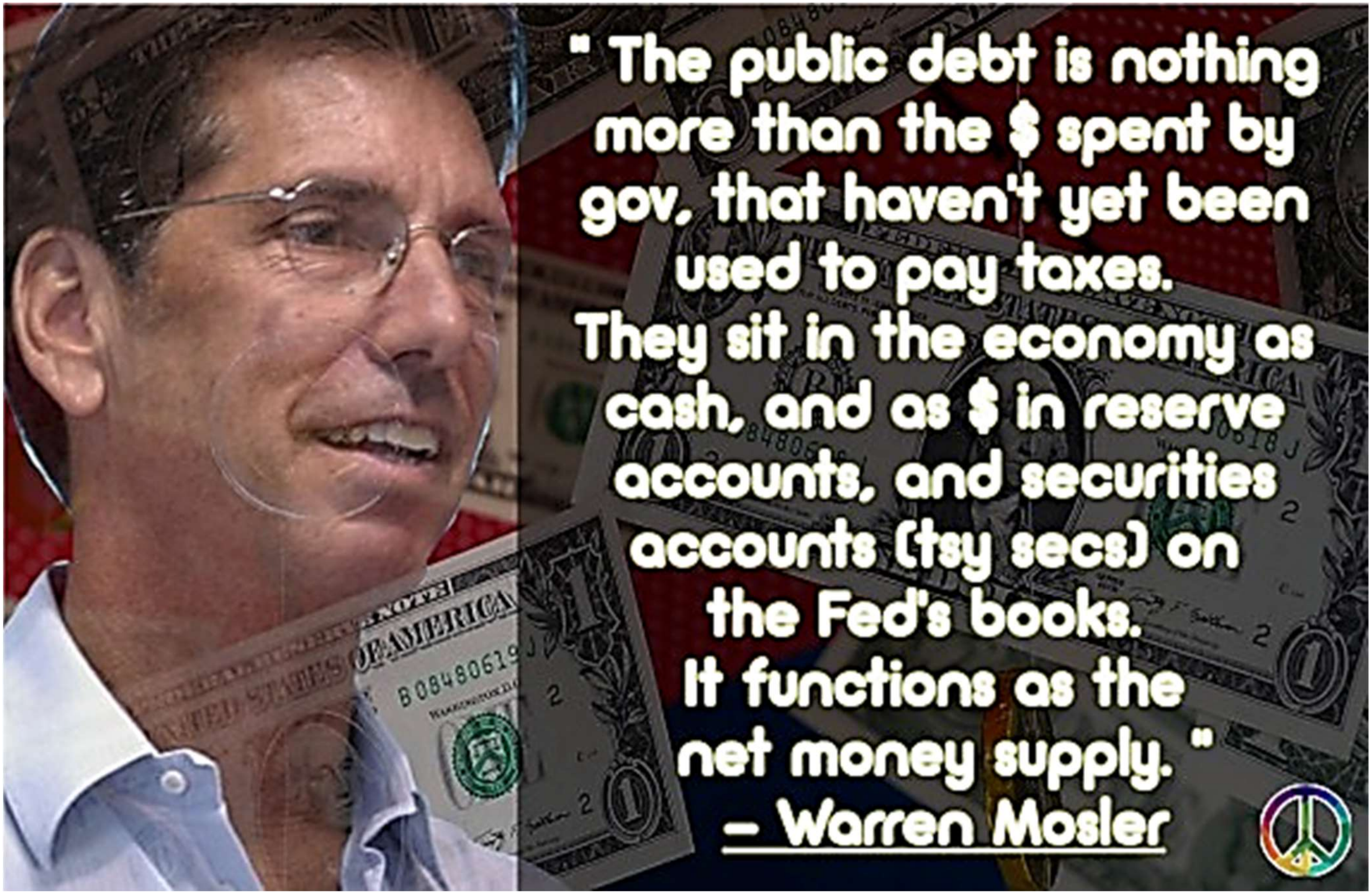
Categories (a) and (b) are basically interchangeable.

Debt drives economic cycles

Private debt should be far more concerning than public debt, owing to (a) its magnitude, and (b) its nature. Private debt increases when families, individuals and businesses possess insufficient savings for financing the conditions required for a vibrant economy. If the volume of government-created money is too low, bank-created money will fill the void as new debt. The latter always adds to the money supply, but it is an asset matched by a liability (unlike the money created by government deficit spending, which is a net financial asset).

Debt repudiation recession

When private debt becomes great enough, many borrowers will begin defaulting on their interest payments, and their loans will be called in. As more and more borrowers find themselves unable to repay their loans, bankruptcy and the repossession of assets will occur. This will have a cascading impact on the overall economy, leading to a debt-repudiation recession.


" The public debt is nothing more than the $ spent by gov, that haven't yet been used to pay taxes.
They sit in the economy as cash, and as $ in reserve accounts, and securities accounts (tsy secs) on the Fed's books.
It functions as the net money supply. "
– Warren Mosler

The Mosler quote is easily misunderstood. In order to understand what Mosler is saying it is necessary to understand some other things about federal government finances and to join the dots.

The aggregate of Treasury securities held by the nonbank private sector is necessarily part of the net money supply. Allowing federal Treasury securities to be relinquished without replacing them amounts to destroying the money supply – not necessarily a good idea.

It is appropriate to think of the aggregate of federal government debt as a form of broad state fiat money, rather than actual debt, notwithstanding that the individual securities are cashed in whenever they reach their term. As a monetary sovereign (ie creator and issuer of the nation's currency) federal government has the ability to (a) create as much money as required at any time for servicing interest payments on its securities, and also (b) replace any of those securities with new securities whenever their term expires. The only real constraint on its money-creating ability without incurring an undue level of inflation is the productive capacity of the economy.

Federal spending creates new money

We read in a FR article by Grattan Institute economist Danielle Woods that "by borrowing through debt, rather than issuing money through creating reserves, the government commits to paying the money back in the future" This narrative is technically and conceptually wrong, because all federal government spending creates new reserves (ESAs). Any Treasury securities issued are paid for using existing reserves, and these are destroyed in the process of payment to the government. The consequent increased fiscal space allows new reserves to be commensurately created when the federal government deficit spends.

Non sovereign debt

State, regional and municipal governments, as well as individuals and businesses, are not monetary sovereigns and don't possess the ability to create money. Their debts are therefore of a fundamentally different nature to federal government debt. Debts incurred by the lower levels of government must be serviced from revenues provided by taxes, rates, fees, fines and public enterprises.

Three questions for the RBA

Three carefully constructed questions directed to the Reserve Bank of Australia by Damien Penston more than four years ago, with the responses received.

Question 1: **Can the RBA ever - under any circum-stances - run out of Australian dollars?**
Answer: **No.**

Question 2: **Has there ever been an occasion in the past where the RBA has refused to honour a payment that was requested by the Commonwealth Government which has been made using the correct format and doesn't contravene any laws or sanctions?**
Answer: **No. That is, a federal payment cannot bounce.**

Question 3: Do any of the monetary aggregates (M1, M3, etc) which are published by the RBA include the balances of any accounts in the OPA Group? [OPA = Official Public Account, referring to any central bank accounts held by the federal government]
Answer: No.

Conclusions: The federal Government has no money in any of its RBA accounts. If you search through the Department of Finance website, they even say that balances in the special accounts (which are part of the OPA Group) aren't money. In other words, taxation receipts do not fund federal government spending.

What is the purpose of federal govt securities?

In the modern money (MMT) narrative, taxation and borrowing do not exist to provide revenue for the federal government. Federal taxation primarily exists to prevent hyperinflation occurring by restricting aggregate demand. What then is the purpose of federal securities? The traditional answer is:

1. Provision of risk-fee financial assets for balancing the portfolios of investment, pension and super funds;
2. Provision of financial instruments required for the RBA to operate monetary policy;
3. Provision of a mechanism for creating net financial assets for the non-bank private sector.

Are federal Treasury securities really needed?

The creation of federal securities is not really essential for the successful operation of a modern economy. Their traditional purposes (see last slide) don't apply if we have:

1. Non-tradeable term deposits provided by the RBA for private sector investors, rather than bonds;
2. Use of tools other than the manipulation of interest rates for managing the volume of money and liquidity;
3. The creation of net financial assets for the private sector via direct (debt-free) federal Treasury spending (supported with the creation of reserves by the RBA).