The flaws in Keynsian borrow and spend

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Summary.

Borrow and spend is a policy with several weaknesses. 1, it involves government borrowing something, that is money, which government can create in limitless quantities any time. 2, the “borrow” part of borrow and spend is deflationary: the opposite of the desired effect. 3, borrow and spend may result in interest rate increases and crowding out. To get round this, governments print extra money and buy back government securities. This is a charade: governments here are engaged in “print and spend” while pretending to effect “borrow and spend”. 4, when borrowings are paid back, the initial reflationary effect is reversed, thus borrow and spend does not have a permanent effect, whereas print and spend does. 5, one of the ways that borrow and spend works is that it supplies the private sector with additional assets (bonds which pay interest). This reduces “paradox of thrift” unemployment. But the private sector actually NEEDS or WANTS these assets, thus there is no need to pay interest to induce the recipients to accept those assets. Put another way, governments should issue zero interest bonds (i.e. cash) not interest paying bonds. 6, Borrow and spend expands the national debt, some of which will be held by foreigners. Paying interest to foreigners when no interest needs to be paid makes even less sense than paying such interest to natives.

For the purposes of influencing unemployment and inflation, print and spend is a superior policy to adjusting interest rates because the latter is distortionary.

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Note. This paper improves and extends the arguments against “borrow with a view to stimulus” in an earlier paper by the same author (Musgrave (2010).

Definitions.

The word government refers here to government and central bank combined, unless otherwise stated. That is not to suggest that independent central banks are a bad idea.

The phrase “print money” does not refer just to physical printing of bank notes, but to the more general concept: creation by banks of money out of thin air.

Only countries that issue their own currencies are considered below. The points made below have obvious implications for common currency areas, like the Eurozone, but these are not considered.

The words stimulus and reflation are used as synonyms.

Introduction.

One of the main points made by Keynes was that in a recession, governments should borrow and spend. However, it has long been known that an alternative is for government to simply create extra money and spend it without borrowing. Indeed, Keynes (1933) himself made the point. To quote him: “Individuals must be induced to spend more…… through the expenditure of borrowed or printed money.”

Unfortunately, the merits of “print and spend” seem to have been half forgotten. As Hillinger (2010) put it, “An aspect of the crisis discussions that has irritated me the most is the implicit, or explicit claim that there is no alternative to governmental borrowing to finance the deficits incurred for stabilization purposes. It baffles me how such nonsense can be so universally accepted. Of course, there is a much better alternative: to finance the deficits with fresh money.”

The purpose of this paper is first, to reiterate some of the arguments in favour of “print and spend”. A second purpose is to argue that print and spend is not just an alternative to borrow and spend, but is actually a superior policy. A third objective is to take the argument still further, and argue that print and spend is superior to the main conventional method of regulating demand and inflation, namely altering interest rates.

For the benefit of those under the illusion that inflation necessarily results from money supply increases, there is a section near the end of this paper dealing with this point. Also, in advocating print and spend, it is not suggested that governments will increase their countries’ money supply EVERY year. Given excess demand and inflation resulting for example from “irrational exuberance”, governments will from time to time need to do a “reverse print and spend”, that is run budget surpluses and rein in money.

The flaws in borrow and spend.

Six flaws in borrow and spend are now set out.

1. When government borrows, it borrows something (i.e. money) which government can create in limitless quantities any time. To borrow something which one can create oneself in limitless quantities and at no cost is pointless. It is worse than a dairy farmer buying milk in a shop when there is a thousand litre tank of milk a few meters from the farmer's house. At least the dairy farmer has the excuse that the milk in the tank cost SOMETHING to produce.

In addition, where government borrows monetary base, as distinct from commercial bank created money, government borrows something which government itself created in the first place.

Wright Patman, (chair of the House of Representatives Committee on Banking and Currency (1965–75)), made much the same point in the following way (Patman 1941).

"When our Federal Government, that has the exclusive power to create money, creates that money and then goes into the open market and borrows it and pays interest for the use of its own money, it occurs to me that that is going too far. I have never yet had anyone who could, through the use of logic and reason, justify the

Federal Government borrowing the use of its own money... I am saying to you in all sincerity, and with all the earnestness that I possess, it is absolutely wrong for the Government to issue interest-bearing obligations. It is not only wrong: it is extravagant. It is not only extravagant, it is wasteful. It is absolutely unnecessary."

2. A second strange aspect of borrow and spend stems from the fact that the whole object of the exercise is stimulus. But the borrow part of borrow and spend involves withdrawing money from the economy, the effect of which is deflationary: the opposite of the desired effect (as others, e.g. Dillard, 1948, p.110, have pointed out). In short, borrow and spend is a bit like throwing dirt over your car before cleaning it: the dirt probably does not a huge amount of harm. It is just pointless.

3. Another questionable aspect of borrow and spend is that additional borrowing will at least on the face of it raise interest rates, which will tend to crowd out private sector borrowing and spending. There is of course some argument as to the extent of this crowding out, but certainly the risk is there. And that crowding out is exactly what is not needed in a recession. To counteract this undesirable effect, governments make sure that interest rates do NOT rise, by buying up government securities. Indeed, most governments in a recession go even further and actually reduce interest rates.

Now when government, 1, borrows, 2, issues securities and, 3, prints money with which to buy those securities, it is in effect engaged in print and spend rather than borrow and spend. This is a charade. That is, when governments claim to be engaged in borrow and spend, they are actually engaged, at least to some extent, in print and spend. And in this scenario, it is legitimate to ask what really has the reflationary effect: borrow and spend or print and spend?

Moreover, since the two polices both have a reflationary effect, one has to wonder what the point of borrow and spend is. That is, is borrow and spend much more than a paper chase?

Incidentally, it is not suggested here that borrow and spend has the same effect dollar for dollar as print and spend. The latter is doubtless a more potent weapon than the former, thus for a given stimulatory effect, a smaller dosage print and spend is needed than borrow and spend.

4. Another nonsense behind borrow and spend is that if borrow and spend has a stimulatory effect, then presumably the opposite of borrow and spend, namely collecting extra tax and repaying the debt, has an equal and opposite effect. There is thus no PERMANENT effect. That permanent effect may or may not be needed. That is, the advocates of borrow and spend sometimes claim that borrow and spend just has a “pump priming” effect, and that is all that is needed.

However, if something more than a pump priming is needed, that is, if a PERMANENT effect is needed, borrow and spend will not produce it, without as a side effect, producing a permanently expanded national debt.

In contrast, print and spend DOES have a permanent stimulatory effect: the private sector has a permanently increased stock of money, which induces that sector raise its spending on a permanent basis.

5. There is a sense in which all demand deficient unemployment is paradox of thrift unemployment. This is not to say that the initial cause of every recession is an increased desire by the private sector to save. But certainly the desire to save played a big role in the 1930s recession and in the current recession. That is in both cases, private sector balance sheets were damaged, which entirely predictably caused private sector entities to try to make good their balance sheets by saving more.

Moreover, even if increased private sector saving has nothing to do with a recession, the way out of recessions is to have both public and private sectors spend more (assuming the aim is to have the proportion of GDP consumed by each sector to remain roughly constant). As to the public sector, it is not difficult to arrange this extra spending: just have government create more money and spend it.

The private sector is different, in that private sector entities cannot be ordered to spend a specific sum of money in a given period of time. Thus governments resort to numerous ways to inducing the private sector to spend: “cash for clunkers” or government backing for mortgages are just two examples.

But a weakness in any measure targeted on specific products (as in the above two examples - cars and houses) is that they are market distorting. However, market distorting measures are unjustified unless it can be shown that the market itself is distorted in some way, which would justify a countervailing distortionary measure (or perhaps “anti-distortionary measure” would be a better phrase). And it is unusual for governments to consider (never mind demonstrate) what market distortions might need rectifying before introducing their own weird selection of distortionary measures. That is, much the most common reason for implementing market distorting measures is that they have populist appeal: they win votes.

For example “Cash for clunkers” is a simple idea which every voter understands. And government backing for mortgages is bound to win votes. If the latter results in ridiculous “no income no job” mortgages and credit crunches many years later which do catastrophic economic damage, that will not worry the politicians who introduce the measure.

At any rate, should some unusually wise government want to induce the private sector to spend more in a non-distorting way, about the only way of doing so is simply to boost private sector incomes and/or feed extra assets to private sector pockets. This ought to raise private sector spending for two reasons. First, a rise in household incomes induces households to spend more. Second, household assets expand, which has the same effect.

Now for the question as to what form these extra assets should take. In the case of borrow and spend, the private sector is supplied with extra assets in the form of government bonds, which pay interest. In contrast, in the case of print and spend, the private sector is supplied with additional assets which pay no interest, that is cash. Which of these two is the better?

Well, there is no need to pay interest on those assets because the private sector actually WANTS or NEEDS those assets if it is to be induced to spend at a rate that brings full employment!

Conclusion: borrow and spend involves government in paying interest, when there is no need to. To that extent, print and spend is a better policy.

Having concluded that borrow and spend involves paying unnecessary interest, this is NOT to suggest that governments should NEVER pay interest on borrowed sums.

The above point regarding unnecessary interest is applicable to where government borrows for stimulus purposes. It is NOT applicable to where government borrows as a substitute for taxation.

To illustrate, if an economy is at full employment, the private sector will almost by definition have the stock of assets which induces it to spend at the “full employment” rate. And in this scenario, if the private sector is to be induced to abstain from consumption so as to make room for extra public sector spending, the private sector has to be induced or forced to engage in the latter abstinence.

Tax is the “force” option, and paying interest on borrowed money is the “induce” option. And there is no avoiding the need for a financial inducement in the latter case: that is, there is no way of escaping the need to pay interest.

But to repeat, where stimulus is the objective, there is no need whatever to pay interest! To that extent, borrow and spend with a view to stimulus is a flawed policy.

6. The final undesirable aspect of borrow and spend is that it expands the national debt, and the larger the national debt, the more of such debt is likely to end up in the hands for foreign entities. Borrowing from abroad CAN make sense. But paying interest to foreign lenders when (as pointed out above) no interest needs to be

paid, is even more pointless than paying such interest to natives.

Should interest rates be used to regulate economies?

A possible objection to the above anti borrowing arguments is that it implies an abolition or near abolition of government borrowing, which in turn might appear to make it difficult for governments to adjust interest rates, because governments effect these adjustments by buying or selling government stock.

To be more accurate, the fact of not engaging in borrow and spend for stimulus purposes does not rule out borrowing as an alternative to tax. But the arguments for the latter are about as feeble as the arguments for borrowing for stimulus purposes (see Musgrave (2010) and Kellerman (2006). Thus there is a good argument for abolishing or reducing ALL forms of government borrowing.

So would a reduced supply of government stock make interest rate adjustments more difficult, and if so, would this matter? There are various reasons, as follows, for think that the answer is a “double negative”.

First, using interest rates to adjust demand is distortionary, since it works only via entities that are

significantly reliant on variable rate loans. It is true that changes in the level of activity by these entities ultimately affects or “trickles down to” other entities. For example, given an interest rate cut, additional activity by the former entities will ultimately trickle down to other entities. But that is not ideal.

In particular, by the time the trickle down is half complete, it is possible the economy is suffering excess demand and inflation, and stimulus from any further “trickle down” is exactly what is NOT needed.

Incidentally, having criticised interest rate adjustments for their undesirable delayed effects, it should be admitted that print and spend has undesirable delayed effects which could be equally bad. That is, a proportion of any additional cash fed to the private sector will be saved, and may be spent exactly when additional spending is not desirable: in an inflationary boom.

In contrast to the DELAYED effects of different policies, and getting back to the INITIAL effects, it is relevant to ask whether print and spend would be less distortionary than interest rate changes. The answer is that with a little ingenuity, the INITIAL effects of print and spend can be almost distortion free.

For example, a payroll tax cut would benefit EVERY employer and employee in the country. That is quite a big chunk of the economy! Admittedly a payroll tax change leaves out pensioners, those on social security,

and perhaps some other groups. But with a little ingenuity these groups could be catered for.

A second reason for thinking a reduced supply of government stock would not matter stems from the fact that there must be some optimum amount of investment in any economy per dollar of GDP. And for a given state of technological development and so on, a plausible assumption is that this “investment per dollar of GDP” will not change given a small change in GDP.

Now the purpose of an interest rate reduction, for example, is to expand the economy a small amount. But the rate reduction will also increase the amount of investment per dollar of GDP: totally illogical!

In fact, interest rate changes are arguably even MORE illogical that the above two paragraphs suggest. Reason is that given excess unemployment, if there is to be any change in the amount of investment per head (or per dollar of GDP), there should arguably be a REDUCTION in the amount of investment per head. Put another way, given excess unemployment, there is arguably merit in encouraging employers, at least temporarily, to employ MORE people for given investment, not LESS!

Third, there is an obvious and serious distortion resulting from low interest rates: asset price bubbles. And in the case of housing, there is the already mentioned catastrophic economic damage that can be done when these bubbles burst.

A fourth reason for thinking a reduced number of or volume of government bonds would not matter is that the fact of not borrowing for stimulus or “substitute for tax” purposes does not rule out borrowing specifically so as to influence interest rates. (As pointed out by Abba Lerner). Indeed, where a government wanted for example to damp down demand by raising interest rates, the effect would come not just from the increased rates. Such a government would announce a willingness to borrow at a higher rate than the prevailing rate. That in turn would withdraw funds from the economy, which (as pointed out under the second objection to borrow and spend above) is deflationary. At least that would be the effect, assuming the money borrowed is not spent.

Fifth and finally, “zero government borrowing” monetary system was set out by Friedman (1948), which suggests that an absence of, or much reduced supply of government securities would not be a problem.

The conclusion is that a reduced supply of government securities resulting from a print and spend policy would not make it significantly more difficult for governments to raise interest rates. And even if it did make it more difficult, that would not matter in that print and spend is a superior policy to interest rate adjustments.

A counter argument.

It could be argued that the costs of borrow and spend are not all that great, in that while this policy IS a pointless paper chase, the costs of paper pushing as a proportion of GDP are small. (Not a strong argument in view of the astronomic costs of the average country's bureaucracy, but never mind!)

However, against that, there is a real and more serious problem as follows. An ever expanding national debt, or a national debt that expands relatively fast, causes a significant number of influential people to campaign for cuts in government spending (or tax increases). The two latter DO HAVE serious economic consequences: the result is a decline in demand in real terms, and means unnecessary unemployment. And this is a very real problem in the U.S. at the time of writing.

Another possible counter argument is that the requirement for government to borrow from its central bank prevents politicians having direct access to the money printing press. (Government and central bank are treated as separate entities here, as distinct from the usage adopted elsewhere in this paper, namely treating the two as the same entity).

The effects of government borrowing from its central bank are very different from where the two treated as one unit borrow from the rest of the economy. At any rate, is there even much to be said for government

borrowing from its own central bank with a view to keeping a distinction between the two?

The answer is “no” because it would be quite easy to frame a set of rules suitable for a “zero borrowing” economy where was nevertheless a clear distinction between government and central bank. For example the rule could be that government must work on the assumption that its spending shall equal what it collects in tax. While the central bank is responsible for inflation (as most central banks currently are), and controls inflation by allowing government additional funds where, for example, unemployment is excessive and inflation is subdued.

Printing money does not necessarily cause inflation.

Having argued the case for print and spend, objections may be raised to the effect that printing money necessarily means inflation. Readers who have a grasp of when money printing does and does not cause inflation can stop reading this paper now.

Printing money does NOT cause inflation to the following extent.

1. As economies expand, all other things being equal, they require an expanded money supply. To illustrate, the money supply of the U.S. is (amazingly) much bigger than that of Liechenstein or Andorra.

2. An expanded money supply is NOT inflationary until it is actually spent (as pointed out by Hume (1752) and by Keynes (1933) and numerous others.) For example if I print a million tons of £50 notes and hide them down a disused coal mine and don't tell anyone what I've done, the effect on inflation would be zero.

And the latter is an illustration which is very relevant to the basic argument in this paper. That is, it was argued above that where the private sector is trying to save extra cash, government needs to print extra cash so as to supply the savings that the private sector requires. That extra cash will not have a big effect until the private sector finds it has TOO MUCH cash. Whereupon there WILL be an effect on demand, and possibly an effect on inflation.

It is of course possible that the private sector will react to an increased money supply by ASSUMING that any money supply increase will cause inflation, and factoring in this inflation into wage agreements, prices of products and so on. However this is totally unrealistic. That is the idea that the average household keeps an eye on the monetary aggregates is fanciful.

The above is typical of the sort of totally unrealistic idea proposed by academic economists with a view to keeping themselves employed at the taxpayers' expense.

Plus the evidence does not support the latter idea. For example the U.S. monetary base expanded by an astronomic and unprecedented amount in 2009. The economically unsophisticated were screaming “Mugabwe” and “Weimar” as a result. The actual effect of that base increase eighteen months later (at the time of writing) is approximately zero. And as regards the future, yields on U.S. long term government stock, at the time of writing, are at record lows, thus the markets are not factoring in rampant inflation any time soon.

3. A significant amount of money printing is made necessary simply as a result of the widely agreed idea that inflation of around 2% is optimum (as opposed to 4%, minus 2%, or any other figure). Reasons are thus.

First, inflation of 2% reduces the real value of the money supply by 2% a year. That depreciation requires money printing simply to keep the value of the money supply constant in real terms (never mind, as pointed out above, the money printing required to keep the real value of the money supply expanding at the same rate as the economy).

Second, assuming a country has a national debt, and that that debt is to remain more or less constant in the long term as a proportion of GDP, further money printing is required to keep that proportion constant. Put another way, that “real term” proportion will not remain constant if the national debt is not expanded in nominal or “dollar”

terms. And that in turn requires and expanded stock of dollars (in the case of the U.S.).

All in all, a fair amount of money printing is required simply to “keep things constant”.

The net result is that most years there will be a net expansion in the money supply. It is only during the occasional burst of excess demand (perhaps resulting from “irrational exuberance”) that government will run a surplus, i.e. need to rein in money and actually REDUCE the money supply.

4. Governments up to about ten years ago tried to control inflation by controlling the money supply. It didn’t work because (with the exception of lunatic Mugabwe type money supply increases) there is little relationship between money supply changes and inflation. At least the relationship is too feeble to make the above inflation control tool a useful one.

5. In the particular case of quantitative easing (of government stock), this is often classified as “money printing”. And certainly the monetary base rises by $X for every $X of government stock QEd. But QE consists essentially of giving holders of one form of government liability (bonds) another form of government liability (cash). To put it in another and figurative way, one type of valuable bit of paper is swapped for another type of valuable bit of paper. Apart from boosting asset prices, and possibly causing asset price bubbles, there is little

reason to suppose this will have much effect on anything: demand, inflation or anything else.

Conclusion: the idea that a money supply increase automatically causes inflation is grossly over simple. To gauge the inflationary effects, it is necessary to look at several factors. Three of those factors are as follows (but there are doubtless several more). 1, the state of the economy. That is, is the economy in a state of excess unemployment and subdued inflation or is it suffering labour shortages and excess demand? 2, Who are the recipients of the additional money: people likely to spend it, or people likely to save it. 3, Does the money supply increase result (as in the case of QE) simply from swapping one asset (bonds) for another (cash)?

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