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Does the government need your money?

Or

Do you need the government's money?

Before we can answer this question, we must first establish where money comes from and how it is created. In the US, there are two types of money: high-powered money (HPM) and bank money. HPM is at the top of the pyramid because it is a direct liability of the federal government, and thus unconditionally guaranteed. Referred to as the monetary base, HPM is created out of thin air (usually keystrokes on a computer) in the process of federal spending. All federal government spending is HPM, and HPM is the only thing it will accept in payment for taxes.

The second type of money is bank money. For everyday purposes, HPM and bank money act the same. They are, however, vastly different. Bank money is created by commercial banks via loans. When a bank makes a loan, it credits the borrower's account with an amount of newly created (again by keystroke) money. This does not add to the bank's net worth. Instead, the deposit (liability) is directly offset by the new loan (asset). The bank's net value doesn't change but the borrower now has more money to spend. Bank money is not guaranteed like HPM. If it was, we would have no need for FDIC insurance. Bank money is an unsecured general obligation of a private bank.

So now to answer the original question. Why do we need the federal government's money? As stated earlier, we need it to pay taxes. Why does the federal government need our money? It doesn't!

Common knowledge dictates that the federal government needs to collect taxes or issue bonds (borrow) before it can spend. In practice, however, the federal government operates much differently.

Federal Reserve accounting clearly demonstrates the reserve effects of tax collection and bond sales. Both reduce HPM. If HPM is what the federal government spends, then the effect should be the opposite.

HPM is a known quantity. It is the sum of currency in circulation plus member bank reserves deposited at the FED. Reserves deposited at the FED are considered HPM because they are convertible on demand into currency.

When we pay taxes, we write a check (bank money). When the check clears, our bank's reserve account at the FED declines by the amount of the check. HPM goes down. The process of paying taxes (bank money) to the federal government reduces the amount of HPM. HPM is what the Government spends. Confused? How about funding Government spending by selling bonds? When we buy a bond, again we write a check which when cleared, reduces our bank's reserve balance, which again reduces HPM.

Don't worry, the federal government isn't going to run out of money. They can create as much of it as they need by spending it into existence. Let's say the federal government needs a new air

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craft carrier, bridge, building, or anything else. The Treasury writes a check which is deposited at a bank. The bank now has a new deposit, and because all banks are required by law to retain a fixed percentage of total deposits as reserves, excess reserves are created. This, in turn, increases HPM.

This begs the obvious question. Why do we have to pay taxes and/or buy government bonds if the federal government doesn't need our money to fund spending?

The answer lies in what the federal government really wants from us. It's not our money; it's our productive resources. They don't want the money to buy aircraft carriers, bridges and buildings, they want aircraft carriers, bridges and buildings. We make the stuff, not the government. They make the money, not us. The gross output of our country doesn't change just because the government wants some of it. If they print the money necessary to buy what they want, they have to make sure that an equal amount of money is taken away from the private sector or else inflation could and probably would get out of control.

Issuing bonds and taxing the private sector helps the government influence private sector spending. Taxing us takes away our buying power. Selling bonds does the same. If we buy a bond, we can't spend money until the bond matures. The opposite actions also hold. Reducing taxes and the government buying bonds (QE) gives us more money to spend.

The real reason the federal government taxes and engages in buying and selling government securities is to influence the largest component of our nations GDP: private sector spending.

Why is this important to a fixed income investor?

The total amount of money in circulation directly affects the cost of money. The cost of money is the interest rate charged to borrow it. Remember supply and demand from economics class? Let's talk supply first.

The public sector (federal government) has no supply constraints when it comes to money (HPM). It creates it at will. It spends it into existence, and the more it spends, the more there is. History suggests that the federal government is going to continue to increase it's debt through spending. Also, all government bonds have stated maturities, but it is common knowledge that they are refinanced at maturity on a continuous basis. Because of this, federal government debt never seems to go down.

Private sector money supply issues are more complicated. Bank money is created when banks make loans. Private sector demands for loans dictate bank money creation. A key difference between public and private money supply is that banks try to only make loans that will be repaid in full and on time. Bank money creation is not designed to be permanent. When the loan is paid back, the bank money is destroyed. What remains is whatever productive resources were generated with the borrowed money. These new resources will hopefully grow our economy.

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This brings us to the demand side of the equation.

Most of the demand in our economy comes from the private sector. When the private sector demands more goods and services than the economy can provide, prices go up. Increased prices lead to increased investment to meet these demands. Business investments are mostly financed by bank loans.

Since the 2008 financial crisis, private sector demand has been tepid at best. This lack of demand has led to less business investment. Less business investment reduces the demand for bank loans. Combine this with historic levels of cash on corporate balance sheets and historic amounts of HPM created by monetary and fiscal policies, and it is clear why there is a lot of money and little demand for it. Interest rates have nowhere to go but down. Tepid demand and high supply will cause the price of money to fall.