

Government Spending and the Money Supply

By William F Hummel

According to conventional wisdom, the Federal government spends taxpayers' money. In reality it creates all the money it spends, and recaptures it with taxes and the sale of bonds. If it failed to do so, the Treasury's general fund would be depleted. In the long run it must spend at least as much as it recaptures. Otherwise it would drain the monetary base backing credit money, which is the main part of the money supply on which the economy runs. In order to influence the amount of credit money that banks issue, the government must control the cost to banks of acquiring base money.

Managing the Base Money Supply

The Treasury pays the government's bills out of its account at the Fed. Those payments inject new reserves of base money into the banking system. Since the increase in reserves would interfere with the Fed's ability to implement monetary policy, the Treasury compensates as follows:

(1) As the Treasury spends, it replenishes its Fed account with equal transfers from its commercial bank accounts where it deposits its receipts from taxes and bond sales. This removes the reserves of base money created by its spending. Aggregate reserves of the banking system therefore remain unchanged *on average*, thereby allowing the Fed to make small adjustments in reserves as needed to maintain control of the Fed funds rate.

(2) The Treasury replenishes its commercial bank accounts with the receipts from taxes, and from the sale of bonds when there is a shortfall in tax revenues. If tax revenues exceed its spending, it removes the surplus by net redeeming its securities. In this way it minimizes disturbances to the aggregate bank deposits of the private sector.

The Balanced Reciprocal Flow of Funds

In effect, the Treasury simply recycles base money previously created by the Fed. Its outflows and inflows move bank deposits and reserves around the banking system without changing the total on average. The Treasury has no use for balances in its own bank accounts in excess of what it needs to cover its near-term payments. It normally holds about one month's worth of government spending, which currently averages about \$300 billion.

The long-term increase in the private sector's money supply is due to (1) net borrowing from banks and (2) the increasing demand for currency. As the money supply increases, the Fed must inject reserves into the banking system to

balance supply against demand at its target Fed Funds rate, its primary monetary policy tool. It does so by purchasing Treasury securities held by the private sector.

Why the Treasury Can Always Sell its Securities

As long as the Federal government enforces tax collection, its base money will be in demand. Since base money earns no interest, when the private sector has more than it desires to hold in the aggregate its only interest-earning alternative is Treasury securities. The Treasury can pay whatever interest rate the market demands, so there will always be willing buyers of its securities.