Towards a definition and validation of debt-free sovereign money

Team FUBI - Financing a UBI

Author: Geoff Crocker

Statement by Geoff Crocker: I would like to thank my colleagues in the FRIBIS FUBI team for their comments on an earlier draft. This does not imply their endorsement of points made in the paper, which is intended to stimulate wider debate.

(1.) Introduction

Within the FRIBIS programme, the FUBI team is examining the proposition for debt-free sovereign money as a means of funding basic income.

This working paper discusses potential definitions of debt-free sovereign money (DFSM), and its validation, both conceptually and practically, including in any current actual or quasi implementation.

The methodology of the paper is to research and evaluate a range of international practice in money creation, particularly recent practice to fund Covid expenditure, and to check their potential compatibility with a definition of DFSM. The comparative analysis refers to three interpretations of current practice, namely,

- the official claimed definition of current practice
- alternative interpretations of actual current practice
- proposals for changed definitions of current practice

(2.) The Research Question

The primer for discussion and research is:

Governments have recently funded large Covid expenditures by borrowing on bond markets. At the same time, existing bond holders have needed to sell bonds, thereby reducing prices. Central banks have therefore bought large amounts of government bonds in the secondary markets, to ensure government funding, whilst maintaining bond prices and reducing their yield.

In cases where the national government, or its exchequer, owns the central bank, is the end result equivalent to a definition of debt-free sovereign money?

The team response to this primer is discussed in the paper.

(3.) The empirical phenomenon

(3.1.) UK

In the UK, Covid expenditure of £400bn has been funded by the sale of government bonds. Meanwhile, the central bank, the Bank of England, has purchased £875bn of government bonds in the secondary market. BoE bond holding now represents 40% of total government debt. BoE is 100% owned by the UK Treasury. The annual interest paid on this debt, and the principal of the debt are between two government departments and therefore cancel to zero. Arguably, BoE could simply cancel the government debt held on its books, or the bonds could be redefined as zero-coupon perpetual consoles.

Similar restructuring has occurred in the USA and the Eurozone. This creates DFSM.

A side effect of the process is that intermediaries in the bond market benefit from BoE purchases by an increase in their portfolio values, and a risk-free margin on their bond sales to BoE.

(3.2.) Japan

Japan has the largest debt/GDP ratio in the world, standing at 266% in October 2020. Nearly 50% of this debt is held by the central Bank of Japan (BoJ). BoJ claims its intention is to sell this debt back into the market, i.e. treating the money created to initially purchase government bonds as short-term central bank money. In 2017, Adair Turner advised the Japanese prime minister and BoJ that the sale of BoJ's huge holding of government bonds is 'impossible', and that they should be converted to interest-free perpetual bonds, which should be gradually 'erased'. In the same year Joseph Stiglitz recommended that all government bonds held by BoJ should be 'invalidated'.
Turner and Stiglitz are both, therefore, arguing for a redefinition of Japan's debt as DFSM. Their advice possibly alters the present arrangement in Japan whereby government debt has to be repaid from general taxation within 60 years.

Whilst the Bank of Japan is not 100% government owned, it does issue banknotes, and creates CBDC to purchase national bonds. On the other hand, the government currently only issues coins, but does have the right to create all forms of money by a cabinet order.

There are wider implications of these observations for Japan. The government is not a profit-earning enterprise. It is therefore a mistake to apply the accounting treatment adopted by commercial enterprises to government accounting. The government as a special institution should adopt its own accounting treatment which is different from commercial companies.

(3.3.) Canada

The Bank of Canada regularly absorbs 20% of government debt by direct bond purchase.

(4.) The Nature of Money – Money as Debt?

There are several views and histories on how money derives its value. Historically, money was linked to a 'gold standard' of the central bank holding of physical gold. This proved both illogical and unsustainable as more money was needed for expanding economies. Money required for expenditure by governments, companies and households exceeded their revenue streams, and so was increasingly financed by debt. Debt in the form of the sale of government bonds became the source of the value of money to the extent that government debt now often exceeds GDP, thus becoming unrepayable. Household debt is also pervasive and unsustainable. The question therefore arises whether, like gold before it, debt i) is necessarily the source of the value of money and ii) can continue to provide the base for money requirement in the economy. Hence a potential case arises for debt-free sovereign money.

Modern money theorists advance the view that money derives its value from its acceptance as a means of tax payment. This is countered by the alternative claim that money derives its value simply from its social acceptance as a means of buying and selling goods, services, resources and assets, i.e. the value of money derives from output GDP, its inputs, and its accumulation as assets. Modern Money Theory proposes the creation of central bank money as debt to be balanced against other sectoral surpluses.

Legally, central bank money is not debt, under any circumstances. It is sui generis and much closer to equity, but it is not like corporate equity either (anon referee). Central bank money is distinguished from commercial bank money creation which is extended to corporate and personal lenders, and so is debt by definition.

Central bank accounting practices for money creation will undoubtedly vary, and this is a subject for further empirical research. A common practice when a central bank creates money to buy government bonds, is for the central bank to record this money creation as a liability in its balance sheet, set against the government bond it now holds. However, there is no counterparty to this liability. The money is created as a virtual artefact. There is no creditor. The central bank does not owe the money it creates to anyone; it does not have to pay it back. It is therefore not debt as normally defined.

The argument is advanced that central bank money may be like debt, if it is created only temporarily with the central bank's declared intention to sell the government bond back to the market, so that the digital money creation is cancelled when the bond is resold to the market. Nevertheless, even for the short time central bank money exists between its creation and its annulment, it is DFSM. Moreover, there is no clear statement of the timescale for the central bank to hold bonds. The liability recorded as the creation of central bank money is essentially put into 'deep freeze'. The bonds held by the central bank could readily be converted to zero-coupon perpetual coupons.

Accounting conventions matter at this point, but they may be an actual rather than a necessary requirement. If the central bank buys bonds directly from the government, under current accountancy practices, this is a credit claim and a monetary liability on the central bank's balance sheet, and a debt in the books of the government. The key phrase here is 'under current accountancy practices', and the challenges are i) whether these practices reflect reality, i.e. in creating new central bank money who owes a debt to whom, and ii) whether these accounting practices are necessarily so, or merely a convention, an artefact which can be readily redefined.

There has been longstanding uncertainty around this question of how central bank money should be accounted in the central bank's balance sheet. Perhaps it doesn't need to be thus accounted at all. Or perhaps the David Ricardo solution of a separate central money creation unit which is not reported in the central bank's balance sheet is feasible and preferable.

(5.) The Concern of Inflation

The concern of inflation is a regular response to proposals for debt-free money creation. The assumption is that when a government borrows to fund its expenditure, then it is withdrawing money from the economy equal to the money it is injecting into the economy via its expenditure programmes. Conversely debt-free sovereign money is argued to simply add new money to the economy without a corresponding withdrawal and could therefore prove inflationary. It is true that when an insurance company or a pension fund buys a government bond, it therefore has less funds available by the amount it has paid for the bond, whereas if a central bank buys a bond by central bank money creation, the central bank does not thereby have less money. However, the funds used by the insurance company or pension fund would not otherwise have been spent into the economy, so the replacement by central bank money creation would not increase income funded expenditure and would not therefore generate any additional inflation. It is also accepted that money creation to fund investment for output growth will not be inflationary by its increase in the supply of goods and services.

It is true that QE programmes have both explicitly targeted, and have achieved, asset price inflation which has occurred alongside low/zero inflation in consumer goods and services. This is a different but significant inflationary process which requires further research, particularly how the price of assets like government bonds feed across to inflation in real assets, particularly housing.

A further argument is that DFSM, by its essentially infinite availability, will allow government profligacy which will itself be inflationary. The reasonable counter-argument is the expectation of responsible government which frames its expenditure policy within the inflation constraint.

A more nuanced argument is that market confidence assumes only short term DFSM, with the expectation that the central bank will shortly sell on its holding of government bonds and nullify its original DFSM creation. If the market feared repetitive DFSM creation with long term bond holding by the central bank, then a crisis of confidence might drive urgent bond sales, depressing prices and raising yields. This hypothesis has yet to be tested and lacks empirical evidence to date even against current substantial central bank bond holdings of undeclared duration. It is a further theme for research.

(6.) Interim Conclusions

The case for the feasibility of DFSM is strong, based on

- Central banks' money creation to purchase government bonds funding Covid spend is or can be defined to be equivalent to DFSM
- The Turner/Stiglitz advice to Bank of Japan is to convert all outstanding debt to DFSM
- Cash is currently issued without incurring debt, so is a variant of DFSM

The case against this interpretation is

- Central bank money creation is defined as balance sheet debt by accounting convention, although there is no creditor counterparty
- Markets treat central bank money creation as temporary, expecting an imminent sale of the same government bonds back to private holders so that it will again count as debt. Failure to implement this expectation will destabilise bond and currency markets, threatening inflation and devaluation. It's not clear that this point essentially reverses the claim that short term central bank money creation is still debt as claimed above.

However

- Defining central bank money creation as debt is an accounting convention, and therefore merely an artefact. It is not necessarily so. An alternative definition of central bank money creation as not-debt is equally valid.
- The claim that bond markets and currency markets will be destabilised if DFSM becomes long-term or permanent is unproven, either by logic or empirical evidence.

We therefore conclude that DFSM is feasible and can offer a source of funding for basic income.