Feast or Famine: Savings Gluts and Liquidity Shortages

L. Randall Wray
Professor, Economics, UMKC
Senior Scholar, Levy Institute
Research Director, CFEPS
Out-of-Paradigm Views on Savings

• Savings can be excessive (Glut) → too much investment
• or insufficient (Shortage) → too little investment
• Govt Deficits “soak-up” savings, crowd out private investment, and threaten solvency
• Trade Deficits “soak-up” foreign savings and threaten solvency
Out-of-Paradigm Views on “Liquidity”

- Excess liquidity → too much spending → inflation
- Liquidity shortage → too little spending → recession/unemployment
- CB must ensure just the right amount to keep spending at right level; CB restricts liquidity in inflation; CB pumps liquidity to avoid recession
Correct Paradigm: Modern Money

- Gov’t-issued sovereign currency
- Floating exchange rate
- Taxes drive money
- Govt spends by crediting reserves; taxes by debiting reserves
- CB sets overnight rate target
- CB adds/drain reserves as needed to hit target
- Should remove self imposed constraints
Aggregate Balance

- GDP identity: \( GDP = C+I+G+NX = Y \)
- Alternative: stock-flow consistent balances
- One sector can spend more than income only if another sector spends less: deficit of one equals surplus of the other
- Surplus of a sector \( \rightarrow \) net accumulation of claims on other (deficit) sector
- Surplus is the “pecuniary accountancy” (or accounting record) of Deficit
- Financial Wealth = Financial Debt (accum. Def)
Accounting for Govt Deficit

- Govt purchases goods and services and makes transfers by crediting accts
- Nongovt pays taxes leading to debit of accts
- \( G > T \rightarrow \text{Govt Deficit} \rightarrow \text{Nongovt Surplus} \)
- Surplus \( \rightarrow \) accumulation of claims on Govt, or Net Financial Saving
Can Deficits be Excessive?

• Sales to govt and transfer receipts are voluntary
• Accumulation of claims on Govt is voluntary
  – Anyone with excess, spends → GDP rises, taxes rise, Deficit falls and equilibrium is reached where: Govt Deficit=Desired NonGovt Saving
  – Effects of portfolio imbalance are only on asset prices (interest rates)
  – Govt spending can be inflationary, beyond full emp, or even before full emp if govt adopts inflationary pricing strategy, but Deficit cannot exceed Desired Saving ($ nominal)
Can NonGovt Savings be Insufficient to “Finance” Deficit?

- Govt spending $\rightarrow$ credit bank accts
- Taxes $\rightarrow$ debit bank accts
  - Taxes do not “pay for” Govt spending
- Deficits $\rightarrow$ Net Credits (=Savings)
- Deficits are a residual, determined by the net saving desires of nongovt sector
- But Savings (net credits) cannot pre-exist Deficits
  - Savings cannot “finance” Deficits
Bond Sales and Monetary Policy

- Given net desired saving, portfolio allocation decisions affect term structure of interest rates
- Govt Bonds are interest-earning alternative to Reserves (both claims on Govt)
- New Issues (Treas) and OMS (Fed) drain Res
- Purpose: to hit overnight rate target
- Bond sales do not “pay for” Govt Def
  - Bond sales are part of monetary policy, drain excess reserves. (OMP add reserves)
Reserves are Nondiscretionary

- Excess Reserves → ffr falls below target
- Insufficient Reserves → ffr rises above target
- Fed can only “pump” exactly the quantity of reserves desired
- Fed cannot encourage spending (or lending) by “pumping liquidity”
- Only the interest rate target is discretionary
- Price rule, not Quantity rule
Current Acct Deficits $\rightarrow$ ROW Savings

- Can divide Non govt sector into Domestic Private + ROW Sectors
- $\$ Net Imports \rightarrow$ ROW $\$ Accumulation
- If ROW $\$ Saving is excessive $\rightarrow$ ROW spending $\rightarrow$ US net imports fall $\rightarrow$ until ROW $\$ Saving at desired level
- ROW $\$ Saving is “pecuniary accountancy” (or accounting record) of US CA Deficit
Financing Current Acct Deficits

• US is the source of $ accumulated as ROW Saving
• ROW Saving cannot “finance” US CA Def
• US CA Def ‘funds’ ROW savings
• If exporters to US do not want $ Saving, can exchange for domestic currency at CB; CB provides domestic reserves to support exports
• Foreign CBs exchange excess $ Reserves for US Treasuries to earn interest
• Excess $ Reserves in ROW can affect $ exchange rate; Floating Rates
• Price not Quantity: CA is sustainable
  – Exchange Rates and Interest Rates can be affected
• Fed Sterilization is about price, not quantity
Domestic Saving

- Within domestic private sector, firms produce → HH income generated
- HH Income → Consumption + Saving
- Firms issue IOUs to obtain funding for resources for production; “Banks” intermediate, issue IOUs to enable purchases by firms
- HH use bank IOUs to purchase Cons output
- Both firms and HH can run deficits or surpluses; Saving = net accumulation of $IOUs
- A Surplus (or Saving) is voluntary—firm or HH sold goods and services to accumulate $ claims
Saving and Investing

• Firms produce C&I goods; only C goods are “available”, but all production $\rightarrow Y$
• Thus I goods $\rightarrow Y$ not spent on Cgoods $\rightarrow$ Saving = “pecuniary accountancy” (accounting record) of Investment
• If S is above desired levels, HH increase C $\rightarrow$ “disinvestment” thru inventory reduction
• If S is less than desired, HH reduce C $\rightarrow$ unplanned inventory accumulation = rising Investment
• Hence, S = I, always, representing production that was not consumed; and must be desired
Inside Wealth vs Outside Wealth

• For every Nongovt financial $ liability there is a Nongovt financial $ asset; Net = 0
• Total “inside” Nongovt Net Wealth = real assets
• Only US Govt is source of net $ financial assets (“outside”) for non govt sectors:
  – Govt Deficit $\rightarrow$ increase Net Financial Wealth
  – Govt Surplus $\rightarrow$ reduce Net Financial Wealth
No Glut of $ Savings

• Nongovt “Inside” net $ financial wealth created annually = zero; all transactions are voluntary
  – Subsequent portfolio adjustments → Prices and returns on stock of $ financial assets adjust

• Nongovt Net $ Financial Wealth created annually = Govt Def; all $ receipts are voluntary
  – Subsequent portfolio adjustments → Prices and returns on stock of Treasuries adjust

• ROW Net $ Financial Wealth created annually = US CA Deficit; all $ receipts are voluntary
  – Subsequent portfolio adjustments → prices and returns and exchange value of $ continuously adjust
    (floating rate)
No Shortage of $ Liquidity

• Fed provides $ Reserves on demand to hit overnight rate targets
• Penalty rate/frown costs at discount window can force ffr above target
• Reducing penalty and creating facility to “market” reserves reduce ffr error
• But facility should operate only on Price, not Quantity
Remove self-imposed constraints

• Provide overdraft facilities for reserves w/o limit
  – Canadian-type system: Target overnight rate, pay target-50bp on deposits, charge target rate on overdrafts; 0 RRR; eliminate Treasuries
• Remove all reqmts for balancing govt budget over period det’d by movements of celestial bodies; ignore resulting Def
• Simplify coordination betw Fed and Treas; it is just internal acctg
• Net Imports are Net Benefit to maximize
• Employment is benefit, Unemp is cost to minimize
• Full Employment can stabilize Prices