

Feast or Famine: Savings Gluts and Liquidity Shortages

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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/drains 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
- $G > T \rightarrow$ Govt Deficit \rightarrow 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 → credit bank accts
- Taxes → debit bank accts
 - Taxes do not “pay for” Govt spending
- Deficits → 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 \rightarrow ffr falls below target
- Insufficient Reserves \rightarrow 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 → ROW Savings

- Can divide Non govt sector into Domestic Private + ROW Sectors
- \$ Net Imports → ROW \$ Accumulation
- If ROW \$ Saving is excessive → ROW spending → US net imports fall → 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 C goods \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 → increase Net Financial Wealth
 - Govt Surplus → 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