

## HOW THE MONEY SUPPLY INTERACTS WITH THE FISCAL DEFICIT.

*I have written a number of articles on Modern Marxist Monetary Theory or MMT which explains the nature of modern money, and which is able to anticipate the movement in prices. This is a follow up article examining current data and price movements using the insights provided by MMT.*

The essence of MMT is that it is legacy value in the form of revenue which circulates current value in the form of newly produced commodities. As I have pointed out previously citing Marx, when examining the nature of money, it is not necessary to distinguish revenue from capital. In this sense capital is merely part of the newly produced revenue some of which is then capitalized or thrown back into production rather than being consumed outside of production.

The act of exchange is therefore the process whereby existing revenue is extinguished through being spent, while on the other side, commodity value or current value is being converted into new revenue through being sold. Viewed temporally in this manner, it can be seen how legacy value in the form of pre-existing revenue circulates current value in the form of commodities being sold.

Revenue in the hands of the holder represents a fractional title to the value already produced, which is why it can act as money regardless of the nature of the state backed (legal) token being used to represent it. More precisely, the stock of money is mainly composed of unspent revenues.

In this article we will be examining what is currently happening to the ratio of unspent revenue and the mass of money or M2. M2 is equal to currency plus easily liquidated savings with terms less than a year. In my version I add in the reserves held by depository institutions with the FED as this is money deposited with the FED normally used to settle accounts between banks at the end of the banking day to account for the movement of deposits and withdrawals between them. Thus the term 'expanded M2'.

There is one final issue to discuss. That is the difference between temporary and permanent money. Bank credit, that is loans to individuals and businesses, is temporary money which has to be repaid. That is why it is a myth to view bank credit as the source of all new money. Only outstanding bank credit functions as money, that is new credit issued less old credit being redeemed on term.

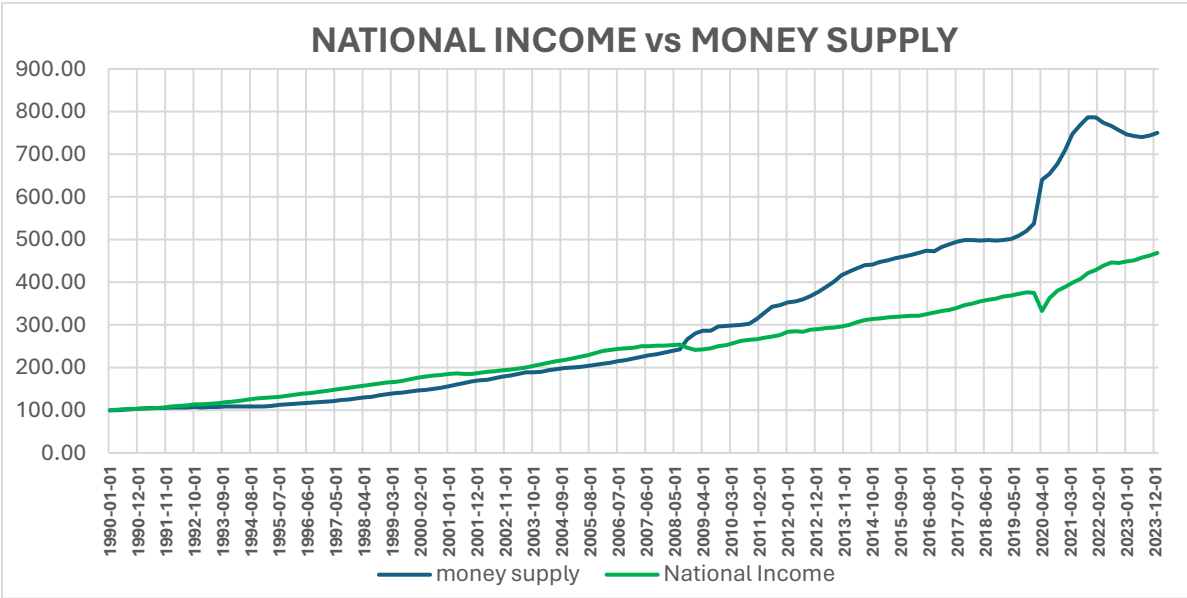
On the other hand monetary policy and fiscal policy, especially the former, can represent permanent money but not always. In the case of *Quantitative Easing* (QE), that is the repurchase of government bonds by newly minted money, that represents permanent money until such time as *Quantitative Tightening* (QT) mops up this excess money or part of it. Quantitative Tightening being defined as the selling of these bonds against the money previously minted to buy them. And if the FED simply lets the bonds expire, then that money remains in the system as permanent money.

Fiscal Policy is different. Its effect is more nuanced. If the Federal Debt is rising it can be said that this is a form of Quantitative Tightening. That is the Treasury is taking on more debt by selling more bonds. This is draining money from the private sector except that it is not. If that debt is being raised in order to fund current spending it can actually increase M2. The reason being that much of the debt which funds government bonds comes from idle hoards, that is the savings of the rich, excess bank deposits, funds held by institutions such as insurance companies and pension funds and sinking funds in corporations. In other words hoards being saved for future obligations or simply funds which have not strayed into the speculative arena yet. Most of these funds would not appear in M2 but the much larger M3 or M4. Thus

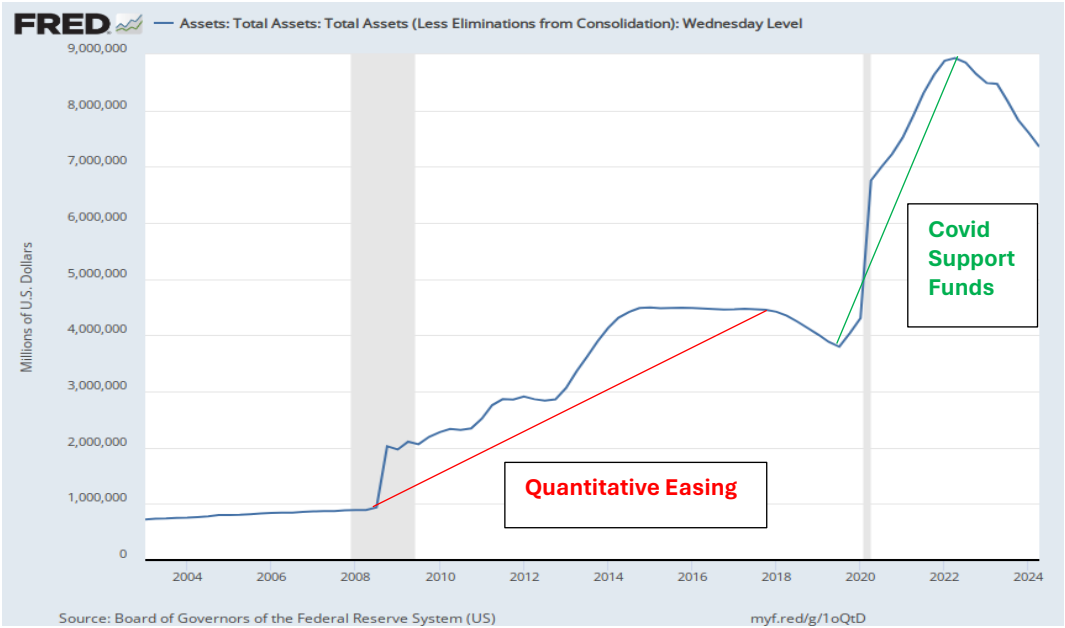
the fear by the Austrian School that the state is crowding out the private sector by over-borrowing is misplaced. If anything, as we shall see, the slowing down in fiscal spending is actually a headwind for the US economy accounting for why it is slowing down.

The effect of Quantitative Easing and Covid support funds can be seen clearly in Graph 1 below. Up until 2008 we see a regular pattern between National Income and M2 which is then disrupted by two surges, the first is from Quantitative Easing post 2009 and then in 2020 from the effect of Covid Support Funds. We note these two surges contribute equally to the eventual gap. Total QE amounts to \$4 trillion compared to Covid funds which added up to \$5.1 trillion. The extent of QE can be seen in Graph 2.

Graph 1.



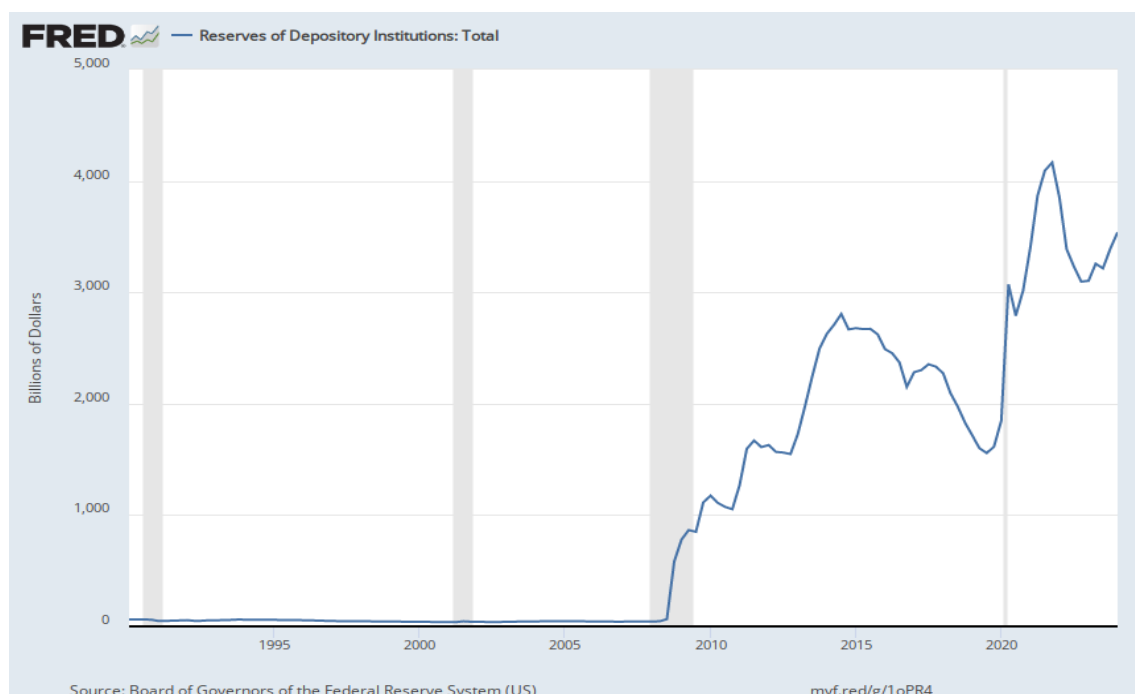
Graph 2.



The contrast between the money injected into the economy via QE and Covid Funds could not have been more different. The former did not affect market prices. It only affected fictitious asset prices, while the Covid funds boosted market prices. In the case of QE the purpose was to recapitalize the banks and improve their liquidity. The effect of the FED's purchases of bonds was to raise the demand for bonds thereby driving up their prices. This gifted the holders of bonds a capital gains bonanza and it meant profits for those who sold their bonds over the years, or revalued their bonds, mainly the banks.

So what did the banks do with this extra money? Well, following the shock of the financial crash and the caution resulting from that event, bank lending was subdued. Thus little of this money ended up being circulated. Instead the banks simply parked this money back with the FED in order to earn parking fees, oops interest from the FED, which currently at 5% is a nice earner. Who needs brains to be a banker? Borrow cheap, lend dear then park any excess funds with the FED. Taxpayers beware. These deposits are called reserves held with the FED and their enormity can be seen in Graph 3. Reserves shot up by two and three quarters trillion Dollars, much, much more than was needed for the usual settlement purposes between the banks. And as QE ebbed post-2015 so reserves started to fall only to be boosted once more in equal measure by the Covid Funds injections from 2020.

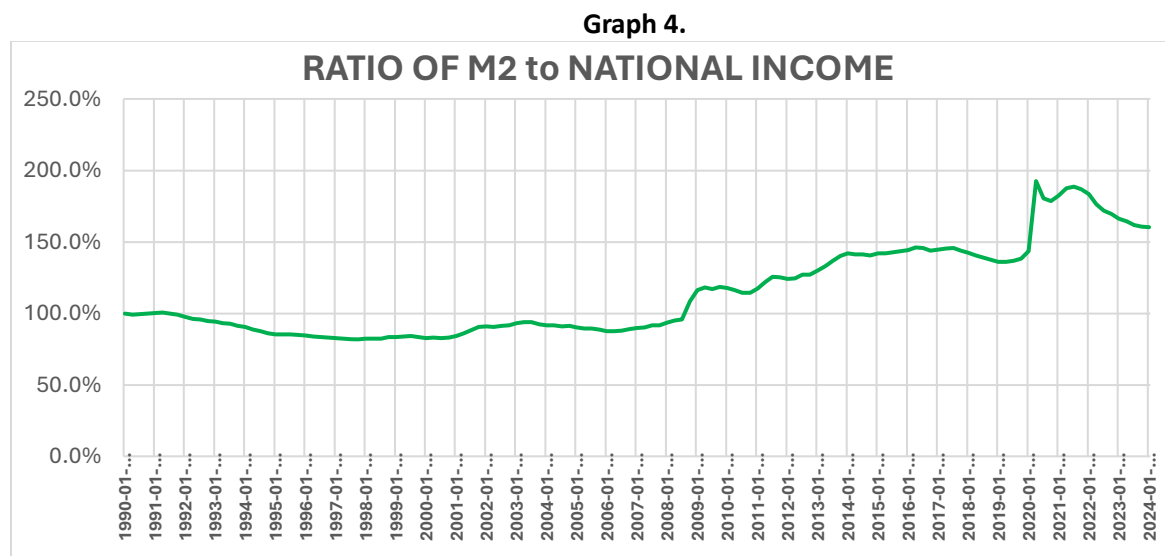
**Graph 3.**



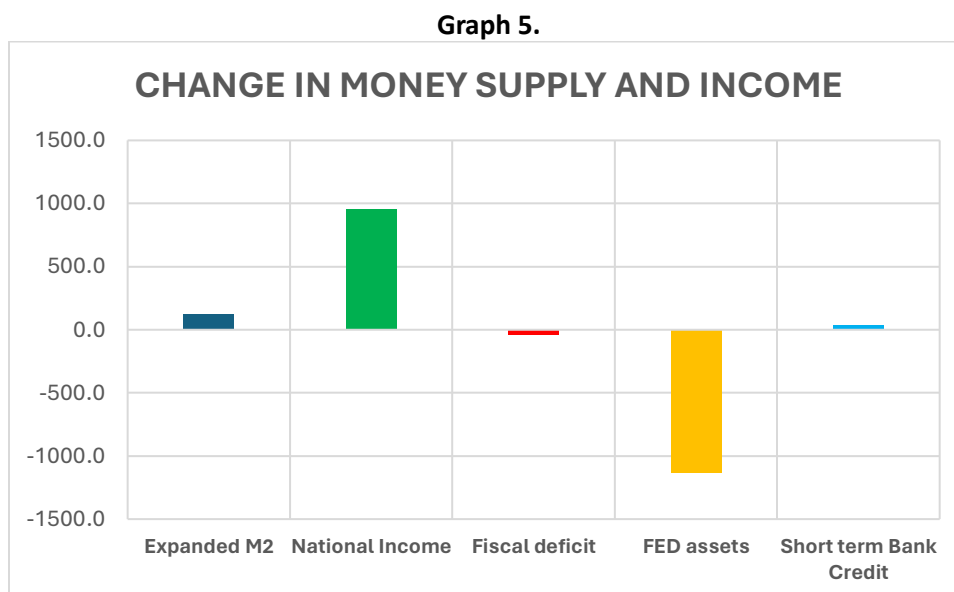
In the context of Covid funding, the pandemic with its combination of supply interruptions, profiteering, and money handed to the deserving needy rather than the underserving rich, the uptick in demand did cause a spike in inflation. Those who argue that it was only the supply interruptions which created the opportunity for inflation, fail to understand modern money. As long as the bulk of M2 consists of unspent revenues, and here we are talking of >90% of the money supply, prices tend towards stability due to revenue acting as the handbrake restraining the money supply. Unspent revenue is fixed because it has already been produced and is thus invariable. Debt on the other hand can be made variable. As long as value is represented on both sides of the exchange it will generally enforce price stability.

In short, unspent revenues represents the monetary ballast keeping prices stable. During Covid as I have shown previously the share of revenue making up M2 fell back to the mid-seventies. This meant what appeared on the one side of the exchange was not only value but debt, the opposite of legacy value, because debt is value pulled forward from the future which has to be repaid. In effect, these promissory notes, value to be reclaimed, always debauches the money supply thereby devaluing the dollar which in turn fueled profit gouging.

The question which now arises is whether this debt is now being reclaimed? Is unspent revenue re-establishing itself as >90% of expanded M2? The answer is yes. As shown in the graph below, which is a ratio of the two graphs found in Graph 1, the gap is closing and heading towards the levels found prior to the Pandemic when inflation was benign.



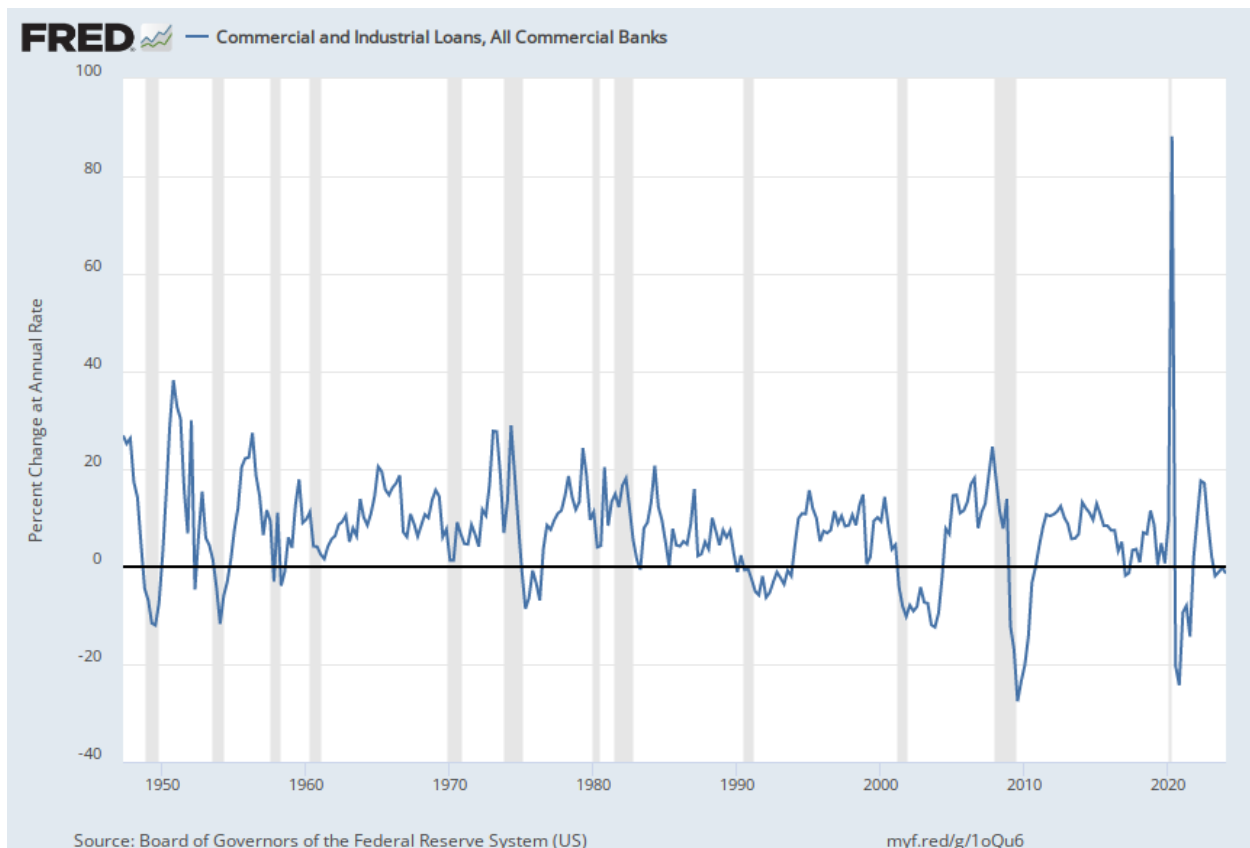
Graph 5 shows the component change over the last year in the make-up of M2. (The data sources and dollar values can be found in the attached spreadsheet 'M2 components'.)



We find the M2 has grown only by half a percent, or by less than inflation. This is due to a slight contraction in the Fiscal Deficit mainly due to the ending of the moratorium on student loan repayments and the ending of legacy spending on Covid support. The FED continues to sell FED Assets mopping up some of the money it hurled into the banking system during QE. And short term bank lending is static due to borrowers being tapped out or at high risk due to potential insolvencies.

This dismal corporate picture can be seen in the Graph below as well. It shows the all important short term loans made to corporate clients by banks. These tend to peak about a year before recessions in the phase of overproduction and then collapse as the recession bites.

**Graph 6.**



What we have not factored for is the effect of speculation on the money supply. Clearly the surge in Share Prices would have withdrawn some money from circulation exceeding that returned through cashing in winnings or some of them. And we have not factored for the movement of money into and out of the USA, although given the scale of foreign buying of government debt in particular, it would have meant a boost to M2 in the US due to the proceeds of this investment being spent within the USA by the government.

### **Discussion.**

Despite these confounding factors the relationship between M2 and unspent revenues has begun to normalize due to a modest increase in the issuance of credit, QT and a stable fiscal deficit. Over the period 1990 to 2008 national income as a share of M2 averaged around 90%. That relationship is being re-established over the last twelve to eighteen months due to the collapse of money sources other than

revenue, but still leaving a large overhang of money inherited from the financial crash and the Pandemic. National Income as a share of M2 is now above 90% once again. In fact, over the last twelve months it has risen by 4%. This rapid rise in one year can be a result of one of three things. A rise in the velocity of circulation (share of revenue spent), a reduction in the formation of money by means of debt, and finally, little or no growth in the money supply itself. The latter two are the most likely cause, not the first. The reason being that market conditions do not suggest an acceleration in velocity.

Let us examine the factors more closely. If it was the case that revenue in relation to M2 was growing despite an increase in the money supply then clearly we would be seeing an acceleration in velocity. But M2 growing at 0.5% or contracting in real terms when adjusted for inflation of 3.1% (The current GDP deflator.) Thus the increase in the ratio of revenue to M2 has more to do with the movement of M2 than it has with revenue. If we remove the effect on the money supply caused by the sale of FED Assets, then relative to M2 national income grew by 3.8% or by 0.7% in real terms over the year. This 0.7% figure is proximate to the [Census Bureau](#) Index of Economic Activity which is an experimental monthly report which shows an economy growing at under 1% over the year, in contrast to the US GDP numbers which are higher. But even here there has been a noticeable slowdown as evidenced by the fall in Q1 GDP growth, a slowdown which has coincided with a fiscal deficit which is no longer growing thereby removing one of the previous drivers of the economy.

Now let us examine the second factor, the effect of debt-fueled money on the movement of M2. Here we have an actual reduction in total of -\$1.146 trillion due to insipid Bank Lending, a static Fiscal Deficit and significant QT. This figure exceeds the \$0.958 trillion added by revenue growth. Without this deduction the expanded money supply would have risen by 5.3% instead of the 0.5% growth it registered. Clearly the money supply is becoming increasingly dependent on what is happening to revenues, whether they are growing and how much of it is being spent.

A stagnant money supply tends towards deflation in the future, everything else being equal. (Today's [CPI Report](#) shorn of its confounding owner occupier rent element registered inflation of 2.4%.) But in these turbulent times nothing is equal. Here we factor for geopolitical risks and climatic risks. Both of which reside on the supply side. Already the disruption to ships sailing through the Suez Canal forcing many to take the much longer route around Africa, together with port disruptions this has caused, has led to freight rates on important routes between Asia and Europe and Asia and the US East Coast, doubling. In fact the FED chair in his press briefing expressed disquiet as well as puzzlement over the increase in import prices. And all this before the summer heat truly kicks in putting into question food supplies, energy supplies and the rhythm of production.

## **Conclusion.**

Therefore any attempt to predict the course of prices this year is a fool's errand which most of the large economic organisations like the IMF have risen to including the FED with its Rot Plots. Nonetheless the methodology set out in this article and previous articles remains sound. Understanding how legacy value circulates current value with each forming the opposing sides of the exchange is essential to describing modern legal tender and as well as anticipating the movement of prices.

Brian Green, 12<sup>th</sup> June 2023.