Government Spending
and the Money Supply

According to conventional wisdom, the Federal government spends taxpayers' money. In reality it spends its own base money and recaptures it with taxes and the sale of bonds. In the long run it must spend at least as much as it recaptures. Otherwise the economy would be drained of the base money it needs to operate. Base money underlies the money supply of the private sector, which consists mainly of bank deposits, i.e. bank money. In order to influence the amount of bank money issued, the government must control the cost of acquiring base money which banks need to cover their depositors' transactions.

The Importance of Government Spending

The Treasury can be viewed as a money pump that continuously recycles base money with the private sector. The outflow due to government spending is matched on average by the inflow from taxes and bond sales. Government spending engages the private sector in work which would otherwise not be performed under private initiative. An example is the building of the interstate highway system.

The outflow also includes various subsidies and transfer payments that may not directly engage work, but are important in redistributing purchasing power. That in turn results in income to firms and their employees. Note that government spending of any kind redistributes income. It is beneficial to the extent that it contributes to a robust economy, with a decent standard of living for all citizens.

Compensating for Treasury Spending

The Treasury pays the government’s bills out of its account at the Fed. Those payments inject new deposits and reserves of base money into the banking system. Since that would increase the money supply and interfere with the Fed’s ability to implement monetary policy, it compensates in the following ways:

1. When tax revenues do not fully recapture government spending, the Treasury recaptures the excess with the net sale of its securities. Conversely if the Treasury receives more tax revenues than needed to recapture its spending, it net redeems its securities. Government spending therefore has no direct effect on the aggregate money supply, on average.

2. As it spends, the Treasury 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.

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 week's worth of government spending, which currently averages about $60 billion.

The long term increase in the public'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 public.

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.