The Gower Initiative for Modern Money Studies

Sectoral Balances

It is important to balance the economy and not the budget

The most basic macroeconomic rule is that one person's spending equals another person's income. It should, therefore, go without saying that as modern economies like ours run on sales, without them an economy is bound to stall. If businesses can't sell what they make (their 'output'), their unsold stocks will increase and they will have no choice but to cut production and shed labour.
When workers are paid, they can choose how much to save out of their wages and how much of their wages to use to purchase goods or services. Not all of the income they spend will, necessarily, be used to purchase goods produced domestically. They may choose, instead, to buy imported, foreign-made goods. Unless the lost sales of domestically produced goods are replaced, an economy will shrink, because there is not enough demand and so businesses will cut back on production.

A domestic economy can sell its output in four ways:

1. Consumer spending (households making purchases, paid for out of income, or by saving less or borrowing more to spend)
2. Government purchases (government spending, net of taxation, injects more spending into the economy – this is called deficit spending)
3. Investment spending (businesses invest in additional capacity when they expect high enough sales in the future to justify doing so)
4. Exports (sales of goods and services to the rest of the world – imports must be netted out to determine the effect of foreign trade on the demand for domestic output).

An economy is balanced if sales of output are high enough to provide full employment to workers without being so high as to cause accelerating inflation. Government deficit spending is the only reliable means to deliver a balanced economy, since a government cannot determine other countries' trade policies or the precise amounts consumers and businesses will spend and invest. People don't always behave in a way that markets predict. If consumer and business confidence is low, people will choose to save more and spend less, and businesses will cut back on investment.

Sectoral balances and fiscal policy

When we talk about the UK economy we are referring to the nation's businesses, households, local and regional governments and other institutional bodies.
Economists divide economies into three sectors:
The private sector (domestic households and businesses, including financial institutions).
The government sector (the issuer of the currency which adds and removes £s as it invests into the economy and taxes back out).
The foreign sector or Rest of the World (the countries with which a nation trades).

Starting with the basic rules of accounting for every financial asset there is an equal and offsetting financial liability, this means that deficits and surpluses must always cancel out across the financial system. If the private sector is in surplus, then by the rules of accounting, the government sector must be equally in deficit.

This is explained by the economist Professor L. Randall Wray:

‘If the government always runs a balanced budget, with its spending always equal to its tax revenue, the private sector’s net financial wealth will be zero. If the government runs continuous budget surpluses (spending is less than tax receipts), the private sector’s net financial wealth must be negative. In other words, the private sector will be indebted to the public sector.’

It is impossible for the government sector and the private sector to run surpluses at the same time. If the government deficit provides the private sector surplus then implications for the economy should be clear. When we add in the third sector (Rest of the World) it can be seen that the three sectors always have to balance overall. In other words, as Professor Randall Wray points out, it demonstrates the ‘important accounting principle that the sum of deficits run by one or more sectors has to equal the surpluses run by the other sector(s)’. Therefore, surpluses and deficits will always add up to zero. As such, in a graphic representation, it will be easy to see that they balance identically as a mirror image.

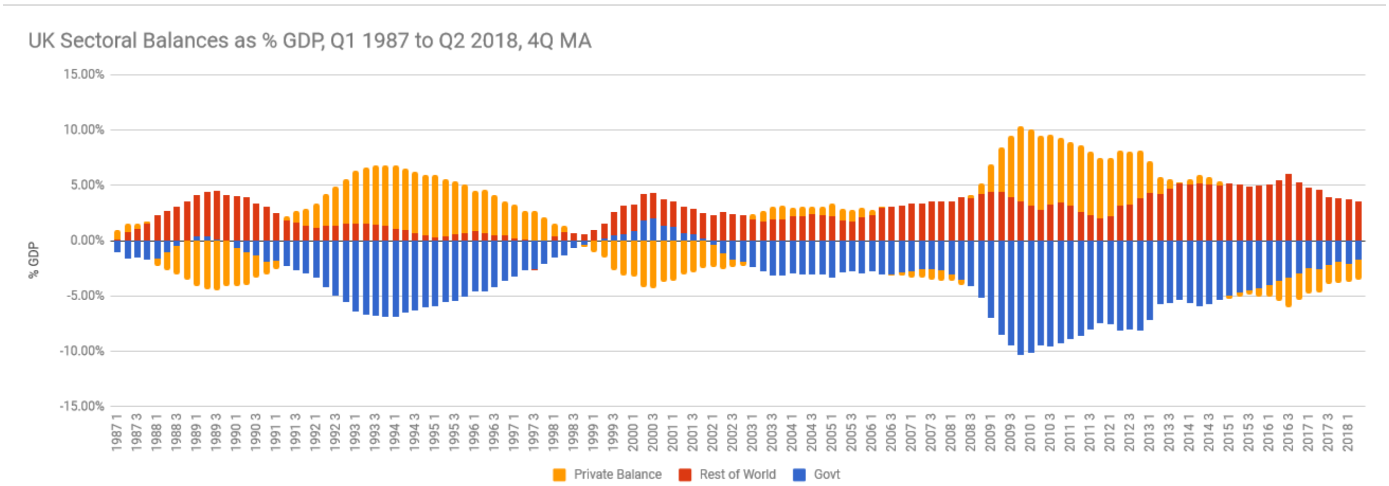

Image: Neil Wilson

Deficits are meaningless without context

To put this into context, the UK is a large importer of foreign goods so has a big trade deficit or, as it is also known, ‘current account deficit’ which matches the foreign sector’s surplus. Other countries sell their goods in £s and save in £s via their trade with us. In order to compensate for the trade deficit, the government must continue to add more of its currency. Failure to do so would mean that the private sector would have to increase its level of debt by at least as much as the trade deficit just to stand still.

Most households will also want to put aside some of their income as savings. They may want to save for a deposit on a house, a holiday, for retirement or against an unexpected occurrence. The government will therefore have to ensure that it is adding enough currency into the economy, net of taxes, to meet the needs of savers. Depending on what the rest of the world is doing, if the government wants the private sector to save rather than go into debt it will probably have to spend more than it taxes.

On a historical note, governments have maintained the so called 'national debt' (which is the accumulation of annual deficits) without default for more than three centuries.

Indeed, a currency issuing sovereign government, like that of the UK, which does not borrow in foreign currencies, can never be forced to default. Its spending and taxing decisions – in terms of output and employment, social inclusion, ecological repair and prevention of excessive household debt – are crucial to the health of the economy and well-being of citizens. It is the role of government to manage its financial flows by observing and matching the demand for money with the productive capacity of the nation.

References:

Professor L Randall Wray – The Basics of Macro Accounting - http://neweconomicperspectives.org/2011/06/mmp-blog-2-basics-of-macro-accounting.html

Professor Bill Mitchell: Deficit or Surplus? - https://youtu.be/h661PkRUbFI

Professor L Randall Wray – Sectoral Balances – Why the Government Must Run Deficits - https://youtu.be/zxDVRISfsls