Money and the Pandemic 2: “Magic Checks”

Anne Emerson - January 2021

In a previous article, the process of money-creation in a modern banking system was described. This article focuses on a related topic: where does the money come from for the issuance of stimulus checks?

Technically, money-creation is a different process from producing stimulus checks. When the Federal Reserve System (the Fed – the U.S. Central Bank) was established in 1914, it was designed to be independent of the U.S. Treasury. This is because money-creation (or destruction) by a central bank supposedly should be used for proper stewardship of the economy, especially for controlling inflation; not for political gain, such as improving the prospects of a political party by generating an economic boost during an election year.

Here are a few explanations of terms. Use of a government’s budget, involving taxing and spending, is called “Fiscal Policy.” This is different from influencing the supply of money and credit, or “Monetary Policy,” which was discussed in the previous article, and is the responsibility of the Federal Reserve. “Policy” in this context means the ways in which these two types of economic controls are supposed to influence economic activity. Understanding how these instruments should work does not imply a preference. This article is neutral in that regard.

The U.S. Treasury’s budget is somewhat analogous to an individual’s budget, in that “income” comes in and “spending” goes out. For the U.S. government, income derives primarily from tax receipts; spending includes purchases of items such as national defense, infrastructure, and social programs. However, unlike a private budget, a government budget does not need to be either balanced or debt-free.

Two explanations are usually given for these differences. One, requiring a balanced government budget may worsen the natural ups and downs of business cycles. For example, as economic activity declines, tax receipts also decline. If the government reduces its spending when tax receipts decline, in order to balance its budget, then economic activity will likely decline more than it already has.

Some analysts advise increasing government spending during an economic downturn, in order to compensate for job-losses and other negative effects of the downturn. It has been suggested that, ideally, a government’s budget should be balanced over the course of a business cycle, rather than for each fiscal year. (That

is, greater government spending at business cycle lows should be balanced by lesser spending during business cycle highs, or "booms.")

The second difference usually given between a modern central government's budget and a private budget is that a central government cannot go bankrupt, because not only can it tax citizens, but also it can "print money"—money-creation, as discussed in the previous article. A third, related, difference is sometimes suggested as well: the U.S. government does not have a fixed lifespan, as individuals do. Debt can be rolled over in perpetuity. Rolling over a debt means that, when an IOU comes due, more debt is issued in order to pay for the debt that has recently come due.

Before we discuss any "magic" origin of stimulus checks, here is a reminder of the relationship between a government's budget and its debt. A government's budget is usually prepared for a short time period, typically a year. Before, during, and after that year, the budget office compares income against expenses. For the year, a budget might have been in the black (money saved), or in the red (money borrowed), or balanced. The total government debt is the cumulative effect of many years of either borrowing or saving. That is, it is last year's budget shortfall or surplus, plus that from the previous year, and so on. According to the U.S. Treasury, as of January 5, 2021, the U.S. Federal government debt was almost $27.7 trillion – the cumulative result of more borrowed than saved dollars.

Back to budgets and banks. If an individual or a business runs a deficit in its bank account, its checks will bounce, unless it has an arrangement with the bank. For example, the bank may offer a line of credit against home equity. For businesses, the timing of receipts and expenditures can vary widely, and a business may have a revolving line of credit. Banks do not usually enter into such arrangements unless repayment of the loan is either guaranteed (with collateral, such as a home or car), or expected (the borrower will make enough money to cover loan repayments).

Back to stimulus checks and the pandemic. How can the U.S. Treasury's bank account increase enough, absent additional tax receipts, so that it has funds to write stimulus checks that won't bounce? Answer: the Treasury borrows the money by issuing government debt, known as Treasuries—Treasury bonds, bills, notes, etc.—short- and long-term. That is, it sells debt, such as Treasury bills, to individuals, companies, and national governments. The Federal Reserve Bank of St. Louis states that U.S. government debt on January 1, 2020 was $23.2 trillion.

What the Fed buys in the process of trying to increase the money supply includes government IOUs similar to those that are created in the process of augmenting the

government’s bank account so that it can write stimulus checks. Thus, buying government debt is a component of Monetary Policy (money creation and destruction—see previous article), while selling government debt is a component of Fiscal Policy (taxing and spending), as described above. Since the Treasury sells on the open market to dealers in securities, and the Fed buys on the open market from dealers, the Treasury does not sell to or borrow directly from the Fed.

One complication is that the Federal Reserve is the Treasury’s banker. This relationship can raise concerns about the independence of the Fed from the Treasury. That is to say, if I have an account at a bank, then the bank and I probably want to have a good relationship with one another. (Just as you and I may have bank accounts at commercial banks, such as Bank of America, the U.S. Treasury has its bank account at the Federal Reserve—the U.S. central bank, or “banker’s bank.” A stimulus check is drawn on a special account at a Federal Reserve Bank, not on a commercial bank.)

Thus, questions are debated today. Is the Fed truly operating independently from the Treasury? And, related, do pandemic emergency measures generate unwanted side-effects? For example, excessive government debt can lead to high and increasing interest rates, difficulty getting credit, insolvency, and default. Many argue that the U.S. government cannot or will not default on its debt. Or, with high levels of government intervention in financial markets, are the rewards and punishments for entrepreneurial risk-taking still appropriate? And, since excessive money-creation could lead to inflation, why does inflation appear to be still low in the U.S., early in 2021?

In sum, the money for the U.S. Treasury’s stimulus checks has been borrowed from U.S. residents and the wider world—from investors who trust the U.S. government to honor its debt. A non-technical explanation for these “magic checks” is that they are conjured from other people’s trust and faith in the U.S. government.

Further Reading

For information on the national debt, see www.stlouis.fed, the US Debt Clock, and www.thebalance.com.

For differing opinions on the impact of stimulus spending, see:
“Will Inflation Return?” *The Economist,* December 12-18, 2020, especially pp. 25-27. And: https://www.washingtonpost.com/business/2020/04/05/what-2-trillion-coronavirus-bailout-is-really-going-cost/