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The State as Financial Intermediary

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Start with two stylized facts about the modern state in advanced industrialized countries. One, the state's credit tends to be the best credit, better than that of business, households, or any (other) financial intermediary; better in the sense that the state borrows at the lowest rate. Two, the state's money tends to be the best money, better than bank deposits, credit cards (household), or trade credit (business); better in the sense that the state's money is a more universally acceptable means of payment. What is the reason behind these two facts?

One view is that these two facts are actually one fact, in that both follow from the state's power to label certain instruments (the state's own issue) as legal tender money, which power makes the state's money trivially the best money. Further, since state debt is just a promise to pay the legal tender money issued by the state itself, there is no possibility of default, and hence state is also the best credit. There is something to this argument, but I am not convinced that things work like that except in extraordinary circumstances such as during wartime.

A second view, the argument for which is sketched below, is that, at least in normal times, what makes one credit better than another, and one money better than another, involves a commercial, rather than a political, calculation. From this point of view, the two facts are different facts—related facts to be sure—but different. Let's look at money first.

Monetary systems are always structured hierarchically. Consider the gold standard system. There is a clear hierarchy from gold (the ultimate means of payment) to national currency, to bank deposits or notes, to other securities. The various layers of this hierarchy are knit together by a particular class of financial intermediary that we may call *market-makers*. Market-makers seek profits by taking a long position in

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some less liquid asset and a short position in a more liquid asset, a spanning operation that exposes them to liquidity risk. It is the willingness of market-makers to span in this way that keeps the layers of the hierarchy in contact with one another, and thus makes it possible for end-users to view the assets in the different layers as substitutes.

Just so, banks have loan assets (long position) and deposit liabilities (short position). They can be viewed as market-makers in their own deposits insofar as they undertake to maintain those deposits at par with currency. Indeed, the market-making function is essential to the profitability of the liquidity spanning strategy since it is the superior moneyness of deposit liabilities, relative to loan assets, that makes it possible for banks to borrow cheaper than they lend. In this sense, it is possible to view bank profits as payment for bearing liquidity risk. Banks manage that risk in part by holding currency reserves. More important than the reserve itself, however, is the ability to replenish the reserve by borrowing from other banks (the Fed Funds market) and ultimately from the central bank (the discount window).

A central bank is also a market-maker but at a higher level in the system, and with a different objective from the profit-maximizing banks lower down. A central bank holds discounts and securities as assets (long position) and issues currency as its own liability (short position). It can be viewed as a market-maker in its own currency insofar as it undertakes to maintain that currency at par with gold, the international money. Under the gold standard, central banks held supplies of gold as a hedge against the liquidity risk involved in this spanning strategy. To some extent, they were able to rely on borrowing from other central banks when they needed to replenish their reserve, but there was no super-central bank with the ability to create more international money. Instead, ultimately, the central bank relied on its ability to sell some of its assets in order to absorb any excess currency issue. If need be, it sold at a low price, which is to say that it raised the discount rate very high, with well-known ramifications throughout the credit hierarchy.

All this is a roundabout way of saying that state money is the best money because the central bank undertakes to make the market in currency in terms of the even better international money, *and* because it undertakes to provide lender of last resort refinance for individual banks who undertake to make the market in deposit liabilities in terms of currency. This is how the gold standard worked, but it is also fairly close to how the modern system works as well. For lack of a universal international money, modern central banks make the market in their currency relative to other key currencies. They may or may not seek to maintain a fixed exchange rate with the other currencies, but even when the exchange rate is allowed to move, central banks still operate to make the market in their own currency in terms of international money. And they still operate to provide refinancing to the national banking system.

Note that nothing so far has been said about state credit. When one views national currency as the liability of the central bank, which is to say as a promise to pay rather than a fiat currency, the creditworthiness of the state no longer appears to stem from its authority to determine legal tender. Yet, apparently, state credit is the best credit. Why?

From a commercial point of view, the quality of a state's credit depends on the balance between expenditures and revenues. In advanced industrialized countries, this balance depends on the accepted legitimacy of spending priorities, which acceptance shows up as willingness to pay taxes. Defense spending is apparently one such legitimate expenditure, but what distinguishes modern states is the extent of social welfare spending, most prominently on health, education, and retirement income security. An understanding of the creditworthiness of the modern state requires understanding this spending. Consider the Social Security system.

It is often asserted that Social Security, unlike a private pension system, is an unfunded, pay-as-you-go pension system. In this view, notwithstanding the trust fund, there are no substantial earning assets to match the huge benefit liabilities incurred by the system. If this were literally true, it would follow that the system must be bankrupt and so also must be the state whose ultimate responsibility is Social Security. Evidently, the market does not think the state is bankrupt, since it remains perfectly willing to purchase state debt at premium prices. Why is this? I think the reason is that the market understands that Social Security is not actually unfunded.

Another way to think about Social Security is that it is a more or less fully funded *social mutual fund* holding ownership claims in the productive capacity of the economy through claims on wages and salaries. In this view, the FICA tax (approximately 10 percent of the wage bill) is permanent, and the capitalized present value of the tax is the asset that backs benefit promises. In this view, the state is a kind of trust into which we place collective assets, and it is also a trustee whom we engage to oversee management of the trust. The state owns some part of each one of us, but we also own some part of it and, through its intermediation, some part of one another.

Once we each view our future Social Security benefits as deriving from our personal share in the pool of socially owned human capital, it becomes clear that we all have a self-interest in the growth and productivity of that capital. Thus, we are interested in human capital formation (education and training) and human capital maintenance (health), and it is not surprising to find the state involved in these activities. The point is that the state is involved not just because of the well-known pervasive market failure in education and health, but more fundamentally because of the common interest in expanding both the quantity and the productivity of the national economy through its people.

In this conception, the power of the state comes not from its monopoly of the legitimate means of violence (prison for tax evaders), but from its democratic legitimacy. In times of collective trouble (war), we voluntarily place more private assets into the collective trust in various ways (taxes, bonds), but these cessions can also be withdrawn by general consent. Just so, if the net worth of the Social Security system (measured correctly as the difference between capitalized FICA taxes and capitalized benefit promises) becomes positive, we can cut taxes or increase benefits. And if net worth turns negative (again, measured correctly), we can raise taxes or decrease benefits. The point to focus on is that the state is the best credit because it is legitimate owner of a large fraction of total productive assets, and so also is legitimate collector of the returns to those assets.

Note that in all this discussion of state credit, I make no mention of state money. The superiority of the state's credit does not derive from its power to designate legal tender, nor does that superiority necessarily imply that its money will be the best money. That said, given sufficient quantity of outstanding state debt, it may well make sense for the central bank to conduct its market-making operations by buying and selling state debt, as most central banks do. Furthermore, given such central bank involvement, it follows that state debt becomes even more attractive to investors, and so sells at an even higher premium, since it becomes the most liquid debt as well as the most default-free. In this way, the superiority of state credit and the superiority of state money reinforce one another, even though they have different logical origins.

In closing, it is important to keep in mind that all of the above applies strictly only to the states of modern industrially advanced countries. These are universally legitimate states in which the current legitimacy of social spending priorities is regularly under review through domestic political mechanisms. They are also legitimate in the sense that they face no substantial external threat to their existence. Whatever may be the case for less fortunate states, the advanced industrialized states find it possible to relegate the use of money issue to finance state expenditure to the absolute last resort, and the prospect of such a last resort is sufficiently remote that it plays no role in commercial valuation. Such states find that placing their money and credit on a commercial basis gives them *more*, not less, degrees of freedom to undertake legitimate projects. The modern state operating as a financial intermediary to do things private markets cannot do—market-maker in currency, social mutual fund in human capital—finds itself not only socially quite useful, but also commercially viable.