Monetization of Debt

Suppose a nation wants to increase either government purchases of goods and services ($G$) or transfer payments ($TR$). The government cannot pay for the goods and services it is purchasing or write checks for the transfers unless it has the funds available in its account (i.e., either the $G$ of $TR$ must be financed.) If this spending is not financed through additional taxation then the nation must issue new debt obligations. In the case of the United States this means the United States Treasury must issue new government debt (i.e., T-Bills or T-Bonds) to finance the spending. Depending on who purchases these bonds, one or more of the following will occur.

1. The nation’s own citizens purchase the bond. In this case the country is financing its deficit by borrowing from its own citizens. This is how the United States financed its efforts in the first and second world wars. Bonds were issued (war bonds) and Americans chose to buy them, mostly for patriotic reasons. Here are two images of United States war bonds from the first and second world wars.
Here is a neat picture of Charlie Chaplin at a huge World War I bond rally in New York City.

And here is a pretty creepy poster exhorting Americans to buy the Liberty Bonds.

In this first case the country is financing the deficit spending by borrowing from its own citizens. The debt must be serviced (i.e., it may later be necessary to issue more bonds to pay interest on previously-issued bonds),
but it does not necessarily need to be paid back. This kind of public debt is quite different from a private debt between two parties.

2. The bond is purchased by the businesses, banks or people from other countries.

In this case the country is financing its deficit spending by borrowing from other countries. As in the first scenario, the debt must be serviced. Because the country owes the debt to others it is more like a private debt between two parties. It is not completely analogous to a private debt because individuals lack the ability to tax to support their borrowing and individuals cannot create inflation (which results in paying back the debt with currency that is worth less than when the debt was issued).

3. The bond is purchased by the country’s own central bank.

In this case the deficit spending is being financed by an open market purchase of government securities. Since open market purchases of government bonds result in an increase in the country’s money supply, we often say that the deficit has been financed by “printing money.” When the central bank (e.g., the Federal Reserve Bank in the case of the United States) buys the bonds we call it monetization of the debt.