Lethame Capital Management

Technology : Research : Investing

Reconsidering Government Deficits: A Balance Sheet View of Fiat Money – Part 1

Summary

In the conventional telling, government deficits are dangerous—a sign of fiscal irresponsibility or economic mismanagement. But this narrative inverts the true logic of a modern financial system. In reality, deficits are not a flaw in the system. They are its engine. A government's decision to spend more than it taxes doesn't drain the financial system—it fills it.

Introduction

The narrative of bad government deficits and reckless Central Bank's is prevalent even at the highest levels of global finance, where this basic accounting identity is misunderstood. Galaxy Digital CEO Mike Novogratz[1]—former partner at both Goldman Sachs and Fortress Investment Group—appeared on CNBC in August 2025 and stated:

"I'm in the lane that Bitcoin is digital gold. And it's a hedge against incessant money printing? It's a hedge against incessant bad fiscal policy in not just the US, but in the whole world…I think you're going to continue to see Bitcoin appreciate ***as long as we have governments that can't spend less than they take in in revenue****…I think our economy is growing faster but it doesn't do anything for our long-term debt and as long as that debt to GDP keeps climbing you're going to see Bitcoin prices keep climbing."*

It is one thing for neoclassical economics to fail to account for how the system actually works[2], but here we have an industry leader—a professional risk taker with direct experience of deploying risk capital in global markets—framing government deficits as undisciplined "money printing" rather than recognising them as the operational mechanism by which net financial assets enter the private sector.

This widespread misunderstanding—among both academic economists and market practitioners—exists because most commentary on fiscal policy is divorced from the actual balance sheet operations that underpin the monetary system. To correct it, we must start from first principles: mapping the institutional structure of modern money. Without understanding the interlocking balance sheets of the Treasury, Central Bank, banking sector, and the non-bank public, it is impossible to see why deficits necessarily expand the net financial assets of

the private sector, and why every asset is matched by a liability somewhere else in the system. This is the foundation on which this paper's argument rests.

The Institutional Structure of Modern Money

To dispel the misconceptions evident even among seasoned market participants, we must begin by laying out the institutional and accounting framework within which all fiscal and monetary operations occur. Without this map of the system, debates about deficits and "money printing" float free of the underlying mechanics, allowing popular but incorrect narratives to persist.

A complete model of the monetary system must include the balance sheets of four institutional sectors:

- **The Treasury**, which initiates fiscal operations;
- **The Central Bank**, which settles payments and manages reserves;
- **The Banking Sector**, which holds reserves and maintains deposit liabilities to the public;
- **The Non-Bank Public**, which holds deposits and government bonds as financial assets.

As the Bank of England[3] showed, private banks create money endogenously by issuing loans, while government deficits add net financial assets by crediting deposits and reserves. In this framework, all financial assets are matched by corresponding financial liabilities in another sector. This fact is reflected in the accounting identity for each entity:

$$\boldsymbol{Assets - Liabilities - Equity = 0}$$

Government Spending and Taxation

When a government runs a deficit, spending more than it takes in taxation, it is injecting new money into the economy. This is not metaphor—it's mechanics. The mechanism is that Government spending increases the non-bank public's bank deposits. These deposits are credits to the private sector's bank accounts but those deposits also appear as liabilities on bank's balance sheets. But to match these liabilities, banks also acquire assets— in the form of reserves from the government.

Specifically:

- **Deposits**, liabilities of commercial banks, are credited to public accounts;
- **Reserves**, assets of commercial banks and liabilities of the central bank, are credited as payment settlement within the banking system.

The process of deficit spending mirrors private bank lending: both add new money into the system[4]. In both cases, **money is created**:

- **Private bank money** is created when banks issue loans (bank asset) and simultaneously credit deposit accounts (bank liability).
- **Government money** is created when spending exceeds taxation, increasing deposits (bank liability to the private sector) and matching them with reserves (asset for banks, liability for the government).

This is the heart of fiat money. It is not backed by gold or foreign reserves. It is backed by accounting, legal authority, and institutional trust. And crucially, it is created by either private banks or the sovereign government, depending on who expands their balance sheet first.

This leads to an important corollary: **a government surplus destroys money**. When taxation exceeds spending, deposits fall, reserves shrink, and the private sector's financial assets are drained. In this way, a surplus is not prudent — it is deflationary. It contracts the financial system in the same way that widespread loan repayments shrink bank money.

The theoretical limit to government spending is therefore not "financing capacity" but the real resource constraint of the economy (labour, capital, raw materials). Moreover, when the non-bank private sector is not expanding credit, the government can run larger deficits with less concern that it will result in inflationary pressure, since its spending is compensating for that shortfall. The common fear of "crowding out" relies on the "Loanable Funds" model, which assumes private banks can only lend out the deposits they have received from their customers i.e. there is a fixed pool of savings. But this model is discredited, by among others the Bank of England[3], the result both private banks and governments create money ex nihilo, so there is no fixed savings pool to be competed over. Under this framework, crowding out cannot occur.

So why might Novogratz be wrong to be concerned—or, in a *reductio ad absurdum*, why doesn't the government go bankrupt from all this deficit spending?

Because the government is not like a household or a firm. It has unique powers:

- It can create money at will.
- It owns vast non-financial assets—public infrastructure, land, sovereign authority.
- And it can never be forced to settle its debts in a currency it cannot issue.

For individuals, insolvency leads to asset sales. If you can't pay your mortgage, you lose your house. But governments don't have to liquidate bridges or airports. Their negative financial equity—meaning their liabilities can exceed their financial assets—is not a constraint, because their true asset is sovereign control over money and law.

And this gives rise to a deeper symmetry in the system:

A positive financial position for the government is a negative position for the private sector—and vice versa.

If the government accumulates financial surpluses, the private sector must run financial deficits. This is arithmetic. The government's red ink is the private sector's black ink. When the government spends more than it taxes, it creates financial assets for the rest of us. When it taxes more than it spends, it takes them away.

The Purpose of Bond Issuance

The reality is most countries don't allow their Treasury's to operate with negative equity[5, 6, 7] Bond issuance not used to finance government spending in operational terms as the Novogratz argument would have one conclude. In modern fiat systems, the Treasury spends by crediting

bank accounts, increasing reserves, the currency of the banking system. These reserves are then used by banks to purchase the bonds that government issues.

So why do Governments issue bonds?

The primary reasons are institutional and monetary:

- **Legal Restrictions:** In most countries, legislation prohibits the Treasury from running an overdraft at the central bank. While the central bank could theoretically settle all Treasury payments, the law typically requires the Treasury to maintain a non-negative balance, necessitating bond sales to replenish it.
- **Interest Rate Management:** Bond sales drain excess reserves from the banking system and support the central bank's ability to target a positive policy rate.

Thus, bond issuance is a legal and monetary policy accommodation—not a financial necessity. This becomes obvious with the observation that the reserves used to purchase the bonds were created by the deficit itself. Governor Waller[8] makes this point directly: in today's ample reserves system, deficits create reserves, and bond sales are conducted primarily to drain reserves for interest-rate control, not to "finance" spending. Moreover, in relation to the payment of interest, the interest paid on government bonds flows back into the private sector as income. Far from being a "cost" in aggregate terms, higher interest expenses increase private sector equity in either the banking sector or the non-bank private sector depending on who owns the bonds.

Why does the Government need to run such a Large Budget Deficit?

The Credit creation we have discussed fuels aggregate demand in a fiat economy because, aggregate demand is not simply equal to GDP; it is the sum of GDP plus the change in debt. When banks extend new credit, they simultaneously create both a loan asset and a matching deposit liability, adding to the stock of spendable money in the economy. This new credit finances spending over and above what could be supported by existing incomes, boosting investment, consumption, and asset purchases. Conversely, when credit creation slows or turns negative, it subtracts from aggregate demand and can trigger recessions if not offset by other sources of spending. Credit creation can originate from the government (via deficit spending) or from banks (via net lending).

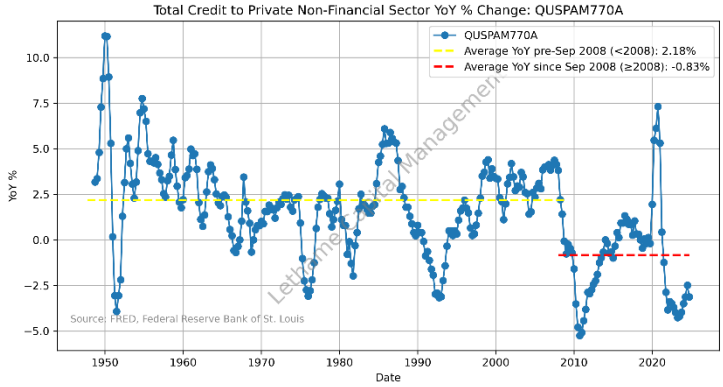
Box: Aggregate Demand vs GDP

Aggregate Demand (AD) is the total planned spending on goods and services, given by $AD = C + I + G + (X - M)$, where C is consumption, I is investment, G is government spending, and $X - M$ is net exports. GDP measures the actual value of final goods and services produced. In equilibrium, AD equals GDP. If AD exceeds GDP, output and prices rise (inflationary gap); if AD is less, output falls (recessionary gap). In a fiat system, AD is driven by net credit creation—from banks via lending and from government via deficit spending. When private credit slows or turns negative, government deficits are essential to maintain GDP growth and avoid contraction.

Current conditions reveal a pronounced and sustained decline in private credit creation, most notably in lending to the non-financial corporate sector. Since the Global Financial Crisis, the banking sector has exhibited a structurally diminished appetite for risk, reallocating balance-sheet capacity away from term lending and toward holdings of risk-free sovereign and agency securities. This shift reflects not only tighter regulatory capital and liquidity requirements under frameworks like Basel III, but also a deeper constraint: the erosion of wholesale dollar funding

capacity and the breakdown of pre-2008 collateralised interbank markets that once underpinned expansive credit growth.

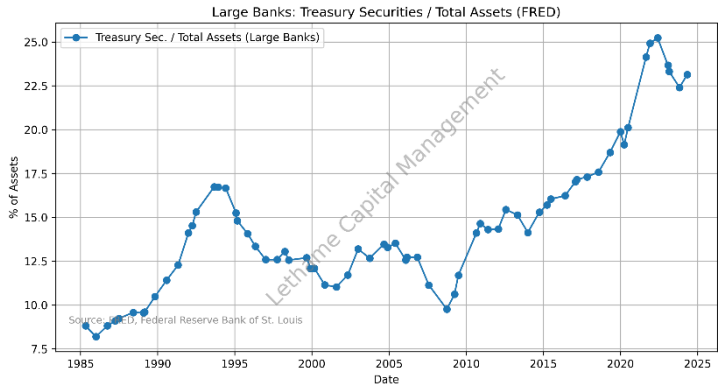
Chart 1: Total Credit to Private Non-Financial Sector (% GDP) YoY % Change



In this environment, banks prefer the regulatory certainty and liquidity profile of Treasuries over the credit and maturity risk of corporate loans. The result is a banking system that, even in periods of economic expansion, is structurally reluctant to create the kind of private-sector credit necessary to drive robust aggregate demand without a compensating fiscal impulse.

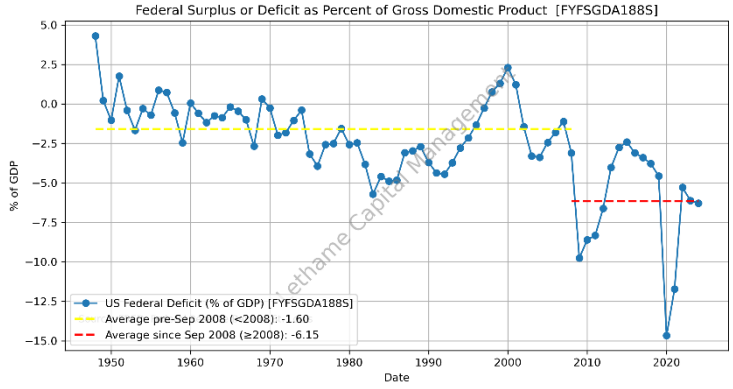
This bank preference for safe assets can be seen in data from the St. Louis Fed in chart 2 which shows that U.S. banks have significantly increased their holdings of Treasury and agency securities relative to total assets, rising from around 15.5% in 2015 to nearly 24% in early 2025, peaking at 26.3% in February 2022. Large banks' holdings of Treasuries grew from 3% of assets in 2013 to 11% by Q3 2024. Over the same period, the ratio of loans to bank assets fell from roughly 70% in 1970 to about 55% today, and banks' share of private lending declined from 60% to around 35%.

Chart 2: % of Bank Balance Sheet in Treasuries & Agencies



If the banking sector is unwilling or unable to expand private credit, the responsibility for sustaining aggregate demand falls squarely on the government. In a fiat currency system, there are only two sources of net credit creation—banks and the sovereign—and if one withdraws, the other must compensate. As the chart 1 *"Total Credit to Private Non-Financial Sector (% GDP) YoY % Change"* shows, private credit creation has trended lower while the federal deficit in chart 3 *"US Fiscal deficit % of GDP"* has widened; whether by accident or design, that fiscal expansion has effectively backfilled the shortfall in private credit and helped stabilise demand.

Chart 3: US Federal Deficit % of GDP



History offers a stark warning: in the early 1930s, while the government was initially running a surplus, the collapse of bank lending, combined with fiscal retrenchment, precipitated a deflationary spiral that turned a severe recession into the Great Depression. Without proactive fiscal intervention to replace the lost flow of credit, the economy risks sliding into the same dynamic—shrinking money supply, falling investment, collapsing output, and mass unemployment. Large budget deficits in such conditions are not evidence of profligacy; they are the only mechanism preventing a repeat of the catastrophic contraction of the interwar period.

Conclusion

What should we conclude when both the economists who run the system and the risk-takers who trade it fail to grasp how it actually works? One possibility is that assets such as Bitcoin morph into speculative manias—quasi-Ponzi schemes—fuelled by the belief that everyone must secure their share of "digital gold" before it is too late…Perhaps. Another is that policymakers, operating under faulty assumptions, make decisions that harm both the economy and the broader public; there is already ample evidence of this in recent history. In such an environment, it is difficult to sustain the belief that markets are truly efficient. While the state of the economic debate is concerning, it inevitably creates opportunities for those willing to think beyond the prevailing orthodoxy.

The underlying reality is unchanged: government deficits inject net financial assets into the private sector and are indispensable when private credit creation is weak. What gives us confidence in this conclusion is not belief or ideology but the discipline of double-entry accounting itself. Because every transaction must balance, and every liability is someone else's asset, stock–flow consistency assures us that the government's deficit is necessarily the private sector's surplus. It is not a matter of opinion that deficits add to private savings; it is simply accounting. Misunderstanding this mechanism leads not only to flawed macroeconomic policy but also to misguided trading and investment conclusions.

Supplementary Note 1: On Emerging Markets and Monetary Sovereignty

Critics often cite emerging market economies such as Argentina as evidence that government deficits inevitably lead to bankruptcy. This comparison overlooks a critical distinction: Argentina does not possess full monetary sovereignty. Historically, a substantial portion of its debt was denominated in foreign currencies, its exchange rate was managed rather than freely floating, and it relied heavily on external funding sources. These conditions mean that, unlike a countries such as the United States, Australia or the United Kingdom, Argentina could not always meet its obligations in a currency it had issued. The recurring crises in such economies stem from foreign-currency debt and balance-of-payments constraints, not from the basic mechanics of fiat money creation in a sovereign-currency system.

Supplementary Note 2: On Bitcoin and Minsky's Ponzi Scheme

In his "Financial Instability Hypothesis", Hyman Minsky[9] used the term "Ponzi Finance" to describe a situation in which the cash flows from an asset are insufficient to cover either interest or principal repayments, and where continuation depends entirely on the ability to sell the asset at a higher price to another buyer. In such a structure, value is sustained not by underlying income generation, but by the expectation of capital gains — an inherently unstable dynamic.

Mike Novogratz's bullish argument for Bitcoin rests on the premise that "incessant money printing" and persistent fiscal deficits will drive sustained demand for Bitcoin as "digital gold." If Bitcoin's price appreciation is indeed driven primarily by public belief in imminent currency debasement, rather than by its own capacity to generate cash flows or provide direct economic utility, then it arguably meets Minsky's definition of a Ponzi structure: its valuation would rely on a continual inflow of new buyers motivated by a shared narrative, not by realised returns.

If, however, Bitcoin's ascent is not principally the product of public fears about sovereign money printing, then the question becomes more complex: why is it rising? In that case, its price behaviour must be explained by other factors — whether as a scarce speculative asset, a technological network with potential future use cases, or as an instrument of portfolio diversification uncorrelated to traditional assets. The critical point is that the rationale for holding Bitcoin should be scrutinised with the same rigour as any other asset: if its price is untethered from both cash flows and sustainable utility, its valuation will remain vulnerable to the same instability that Minsky warned characterises all Ponzi Finance.

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