Glossary entry: sectoral balances

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I posted this new glossary entry yesterday afternoon. I was astonished to find I had not written an entry on sectoral balances before now, so I made good the deficit.

Sectoral balances describe a macroeconomic accounting framework that shows how the financial positions of the main sectors of an economy are interrelated when stated in their own currency, and why they must sum to zero.

In any economy, total financial surpluses and deficits must balance. One sector's surplus is necessarily another sector's deficit. This is not a theory or a policy preference. It is an accounting identity that holds at all times.

The framework is most commonly presented using three broad sectors:

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The government sector

Central and local government, including the public sector as a whole.

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The private domestic sector

Households and businesses combined.

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The foreign sector

The rest of the world, captured through the trade and current account balance.

That said, it is also possible and often analytically useful to split the private domestic sector into households and the commercial (or corporate) sector. This allows more precise analysis of whether deficits and surpluses are being driven by household borrowing, corporate investment behaviour, or retained profits. As a matter of fact the UK government conventionally reports sectoral balances using four sectors:

* government,
* households,
* corporations, and
* the rest of the world.

This disaggregation helps identify where financial stress or excess saving is actually occurring within the economy.

The sectoral balances identity can be stated simply:

Government balance + Private sector balance + Foreign sector balance = 0

Or, when disaggregated:

Government + Households + Corporations + Foreign sector = 0

Several implications follow.

First, government deficits are not inherently problematic. When the private sector wishes to save, for example, during a period of uncertainty or recession, or when the country runs a trade deficit, a government deficit is the mechanism that allows those savings to exist. Attempting to eliminate the government deficit under such conditions can only force the private sector into debt, a move that is usually economically unwise.

Second, trade deficits matter. If a country imports more than it exports, the foreign sector is in surplus. Unless the government runs a deficit to offset this, the private domestic sector, households, firms, or both, must run a deficit instead. Understanding this is vital, but commentators or politicians rarely refer to it.

Third, austerity has predictable effects. Cutting public spending or raising taxes to reduce government deficits does not remove deficits from the economy. It transfers them to households and firms. The result is usually weaker demand, higher private indebtedness, and greater financial instability. Austerity is, therefore, almost always economically counterproductive.

Fourth, “balancing the books” for government is not analogous to household budgeting. Households cannot create net financial assets for the rest of the economy. Governments that issue their own currency can. Sectoral balances explain why treating public finance as if it were household finance is conceptually wrong.

The sectoral balances framework is most closely associated with the work of ***Wynne Godley***, ***whose analysis proved prescient in identifying the unsustainable private debt dynamics that preceded the global financial crisis.***

Within the Funding the Future framework, sectoral balances are central to understanding:

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Why public deficits often reflect private saving preferences.

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How financial instability emerges when household or corporate deficits persist, or when governments react inappropriately to them.

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Why fiscal rules that target arbitrary deficit limits are economically illiterate.

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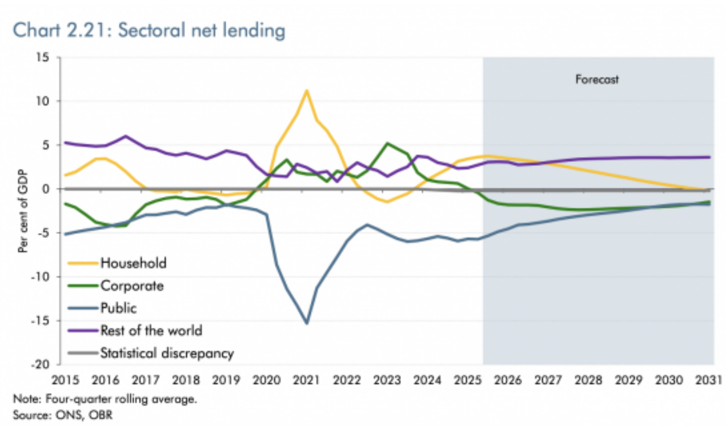
How governments can support stability, care, and capital maintenance across the whole economy

Sectoral balances do not tell governments what they should do. They explain what must be true. Sound economic policy begins by respecting these constraints, rather than denying them.

Sectoral balances are frequently portrayed as a chart. This one comes from the UK government's Office for Budget Responsibility forecasts published in November 2025:



The balances above zero represent sectors in surplus and that are saving, and those below zero represent sectors in deficit or borrowing.

The balances always equal zero. The moral is that for every saver there must be a borrower, as double-entry bookkeeping also makes clear, thereby emphasising the accounting logic that must be reflected in sound economic management.