The President's Address on the Debt Ceiling: An Exercise in Fantasy

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Departments:
Department of Bust Out Profit Models and Vampiric Capitalism [1]
Thread:
Corporatism [2]
Class Warfare [3]
Economic Apocalypse [4]
Tags:
congress [5]
deficit [6]
Debt Ceiling [7]
deficit spending [8]
national debt [9]
MMT [10]
Modern Monetary Theory [11]
Scott Fullwiler [12]
beowulf [13]
14th Amendment [14]
coin seigniorage [15]
debt limit [16]
wigwam [17]
proof platinum coin seigniorage [18]
PPCS [19]

[Welcome, Naked Capitalism [20] readers! --lambert]

Many people have been, deservedly, very quick to jump on John Boehner for the lies he told in answering the President's Address; but they have been a lot less anxious to lay out the lies or at least falsehoods told or implied by the President, himself. I don't intend to excuse the Speaker's lies or the Speaker, by showing that the President doesn't have clean hands. I don't intend to say that lying is alright because everybody does it. All I want to do is show that the President was feeding us fantasy too, because I believe, strongly, that we won't solve our national problems if we don't firmly reject fantasy, whoever may be its author. So, let's look at some quotations from the President's speech, and see where the fantasy is.

> ?For the last decade, we?ve spent more money than we take in. In the year 2000, the government had a budget surplus. But instead of using it to pay off our debt, the money was spent on trillions of dollars in new tax cuts, while two wars and an expensive prescription drug program were simply added to our nation?s credit card.?

No. Mr. President, during the years the Government had a budget surplus, the Government simply borrowed less than it did in other years, and also less than it paid back when its debt instruments came due. So, the Government did not use its surpluses to ?pay back? part of the debt during the years of surplus, and no money was saved for future years when it was then spent on new tax cuts, new wars, and the drug prescription program.

As for the ?our nation's credit card? business, the Government's ?credit card? situation is very different from our own. First, the limit on the Government's ability to issue debt is not based on the Government's ability to borrow, or on the Government's ability to generate financial assets, which, aside from Congressional constraints, is constitutionally unlimited. Nor is the limit imposed by any creditor, as it is with us.

Instead, the limit on what the Government can borrow is determined by the Government itself. Specifically, it is determined by Congress which imposes the debt ceiling, now causing a fiscal crisis. Without that ceiling, that self-imposed constraint, the limit on what the Government can borrow in US Dollars is indeterminate, if it exists at all.

Second, you and I can't keep adding debt to our credit cards, not only because we have a limit, but long before we reach such limits, we may well want to stop adding debt, because our ability to maintain and pay off our debt burden, may be running out. That ability is limited because we can't produce financial resources at will.

The Government is different however. It is not like a household [21] or even the largest corporation. It is not the user of our national currency. It is the creator of it. **All of our dollars come from the authority of the Government to spend, and, in the act of spending to create dollars.**

If the Government has debt, it can always pay that debt simply by marking up the accounts of its creditors. Also, unlike your household or mine, it doesn't matter how much is on the Government's credit card, it can always repay its debts whenever they come due, unless Congress does something stupid to stop it from doing so.

In fact, its own constraints aside for a moment, the Government has precisely the same ability to repay its debts, however high those debts are, and however high its debt-to-GDP ratio is, so long as those debts are owed in the currency (USD) it has the authority to create. It doesn't matter whether the Government owes $14.3 Trillion, or $30 Trillion, or only $50,000. Its ability to pay, self-constraints aside, is exactly the same. It doesn't matter if its debt-to-GDP ratio is 10% or 100% or 300%, it's ability to meet its debt obligations is exactly the same, if it only decides to shed its self-constraints.

So, when President Obama says or implies that we can't keep putting debt on our national credit card what is he really talking about? He's not talking about the Government's intrinsic ability to pay or not. What he's talking about is that Congress has 1) placed a debt ceiling on the Executive Branch's ability to borrow, and 2) passed a mandate requiring the Government to issue debt when it deficit spends. These are Congress's constraints on the Treasury and they are causing our current so-called fiscal crisis, **assuming the President's continued unwillingness to raise revenue for deficit spending other than by issuing more debt.**

The austerity mavens, including the President are telling us that we, the people, have spent too much and run up debts that are too large on our national credit card when Congress has a) required us to use our credit card and, as a result, maintain and increase our national debt, and then b) given us a ceiling of debt which they raise from time-to-time, which has nothing to do with our Government's ability to pay. How unjust is it to create this Catch-22, claim there is an objective problem with a national debt that only exists due to their own restraints, and then say to us, after they've just finished extending the Bush Tax Cuts for the rich and providing an estate tax giveaway, that this phony fiscal crisis requires that everyone (except the rich, of course) accept ?shared sacrifice??

It is not true that we can't keep placing debt on our national credit card, so long as Congress removes its arbitrary and unnecessary debt ceiling. If it does that we **can** keep placing debt on that credit card if we want to without threatening our solvency as a nation.

It is also not true that we must keep issuing debt instruments and keep increasing the national debt when we want to deficit spend, because of some intrinsic feature of the economic system. As I've written in many recent posts [22], we can generate all the revenue we need by using proof platinum coin seigniorage [23], including the revenue we need to pay the national debt entirely [24], as US debt instruments fall due.

In connection with his reconstruction of how the nation came to this pass Mr. Obama said that as a result of the tax cuts, wars, and the prescription drug plan:

> ?. . . . the deficit was on track to top $1 trillion the year I took office.?

But this anticipated deficit was not due simply to these factors. Most of the anticipated $1 Trillion deficit was due to the loss of tax revenues accompanying the Crash of 2008. If not for the recession, the tax cuts, wars, and prescription drug costs would not have produced a deficit of this size.

> ?To make matters worse, the recession meant that there was less money coming in, and it required us to spend even more -? on tax cuts for middle-class families to spur the economy; on unemployment insurance; on aid to states so we could prevent more teachers and firefighters and police officers from being laid off. These emergency steps also added to the deficit.?

They did, but what is misleading in this account is that the President fails to tell us is that his grossly inadequate stimulus left too many people unemployed, and provided so little assistance to the States, that while it stabilized the unemployment rate, it did so at a very high level ensuring that Federal tax revenues would remain low and that the deficit would still be very high; but without the benefit of having enabled full employment.

> ?Now, every family knows that a little credit card debt is manageable. But if we stay on the current path, our growing debt could cost us jobs and do serious damage to the economy. More of our tax dollars will go toward paying off the interest on our loans. Businesses will be less likely to open up shop and hire workers in a country that can?t balance its books. Interest rates could climb for everyone who borrows money -? the homeowner with a mortgage, the student with a college loan, the corner store that wants to expand. And we won?t have enough money to make job-creating investments in things like education and infrastructure, or pay for vital programs like Medicare and Medicaid.?

And later he says:

> ?For the first time in history, our country?s AAA credit rating would be downgraded, leaving investors around the world to wonder whether the United States is still a good bet. Interest rates would skyrocket on credit cards, on mortgages and on car loans, which amounts to a huge tax hike on the American people. We would risk sparking a deep economic crisis -? this one caused almost entirely by Washington.?

The falsehood here is assuming that the bond market actually controls the interest rates that Governments like the United States must pay. Sure, they can determine interest rates if the Government and the Fed sit idly by, and lets them do so. However, the Federal Reserve and the

Treasury, can target bond interest rates and set these for the bond markets by manipulating overnight bank reserves. Specifically, one way to do this, is that the Treasury can cease issuing long-term bonds, and sell only three-month bonds. Three-month bond interest rates are generally controlled by overnight rates for bank reserves, and overnight rates can be driven down to near zero by flooding the banks with excess reserves. That's basically how the Japanese keep their bond interest near zero, even with a debt to GDP ratio of nearly 200%, and that's how we can do the same.

Alternatively, the Fed ihas driven down interest rates through its policy of Quantitative easing (QE). QE currently involves providing banks with cash reserves in return for non-cash bank assets including Treasury Bonds. QE results in an increase in cash reserves, which drives down overnight interest rates for borrowing such reserves. Low rates in the reserve market again, drives down bond market interest rates on three month Treasuries, and exerts downward pressure on bond market interest rates across the board.

Yet another move we can make to remove the effects of the bond markets and the ratings agencies upon public finances, is for the Treasury to stop issuing debt for every dollar it deficit spends. It can do this by using coin seigniorage to generate additional revenue, and by borrowing only for a portion of its deficit spending. If Treasury did this, interest rates in the bond market would be driven down because of the shortage of treasury bonds in the marketplace.

Of course, if Congress allowed the Executive to deficit spend without issuing debt, or the Executive decided to deficit spend only after raising revenue through coin seigniorage, then the Executive Branch could choose to issue no more debt, and then bond market interest rates wouldn't be an issue at all. So none of the effects described by the President just above would happen, all the problems he points to are due to more debt causing higher interest rates through the bond markets. If increasing debt can't cause that, because of interventions outlined above, then the bond market/interest rate scare is ?off the table.?

In short, the bond markets aren't in control of US public finances [25]. They are not in a position to influence what our taxing or spending policies ought to be, or whether we will default on our obligations.

> ?This balanced approach asks everyone to give a little without requiring anyone to sacrifice too much. It would reduce the deficit by around $4 trillion and put us on a path to pay down our debt. And the cuts wouldn?t happen so abruptly that they?d be a drag on our economy, or prevent us from helping small businesses and middle-class families get back on their feet right now.?

Calling his plan ?balanced? is just propaganda. First, it assumes that there is a deficit/debt problem; but this assumption is based on the idea that the US Government can become insolvent or is otherwise constrained in its spending by economic necessity. It also assumes that we've borrowed too much, and that this requires us to slow down deficit spending over time. However, these assumptions are just false. As the currency issuer, the US can't ever run out of money, and the only real world constraint it has on its spending is demand-pull inflation, which we needn't worry about until we've reached full employment.

Second, $4 Trillion over 10 years in spending cuts and/or increased taxes, averages out to $400 billion per year less money either going into the private economy from the Government sector, or being taken back by the Government. If the spending is high fiscal multiplier spending, as much of it appears to be, then we may be looking at as much as $1 Trillion per year in reduced GDP. Anyway you slice it friends, that will cost jobs, careers, family hardship, and lower economic growth, and it is unlikely to reduce deficits very much or at all, simply because the effects of the economy's automatic stabilizers will ensure that more government spending and less taxes will result from these cuts.

Third, this $400 Billion per year of ?shared sacrifice? which is supposed to ensure that no one suffers too much is, to use a popular phrase of yesteryear, ?lipstick on a pig.? We know that the impact of the spending cuts contemplated will fall disproportionately on the poor and the middle class. They will be ?sacrificing? income, jobs, and services that are very important to them, but any ?sacrifices? made by the wealthy and large corporations will be largely symbolic and will not cut to the bone.

Fourth, the President says that the cuts wouldn't happen so abruptly that they'd hurt the economy. But this assumes that current Government deficits are large enough to compensate for savings desires and imports, and that the economy has already received enough of a boost that it will fully recover by the time the full impact of austerity is felt. If they are not large enough, and the economy doe not recover; then what? Do we then follow this inflexible austerity plan and go ahead withdrawing net financial assets from the private sector at the rate of $400 Billion per year, in the expectation that this will lower the debt-to-GDP ratio?

> ?So the debate right now isn?t about whether we need to make tough choices. Democrats and Republicans agree on the amount of deficit reduction we need.?

Democrats and Republicans do not agree on the amount of deficit reduction we need. Nor do they agree on how deficit reduction should be achieved. There are even many Democrats, though, perhaps not in Congress, who believe that there is no debt or deficit problem at all, and that the President's whole exercise in austerity is motivated by a false economic ideology, and by a desire to show ?the independents? that he is a responsible ?bipartisan? grown-up who deserves their support in 2012. Here he is using the left-right frame, viewing the independents as people in the middle who are relatively homogeneous and ideologically disillusioned with the right and the left.

So, he thinks he can pick up these folks ?en bloc? by showing that he has made both progressives and conservatives angry at him. In this, I think he is ignoring the possibility that there are independents from all parts of the left-right spectrum, who have become independent because the two parties represent their interests very badly, preferring to see to it that the wealthy and the corporations are represented at the expense of their constituents. In any event, President Obama's attempt to appeal to independents may fail, because they really have no interest in his independence relative to the bases of the legacy parties; but care much more about his actions in supporting the big banks, a corrupt financial system, continued globalization of the economy, and failure to produce jobs, and viable health care reform for everyone.

> ?That?s not right. It?s not fair. We all want a government that lives within its means, but there are still things we need to pay for as a country -? things like new roads and bridges; weather satellites and food inspection; services to veterans and medical research.?

We do have to live within our means; but a phrase like this is meaningless, when it comes to the Government's ability to generate new net financial assets in the private sector. That capacity is unlimited. And while we do have to worry about demand-pull inflation under certain conditions. The US never has worry about running out of money as do, for example, the members of the Eurozone or other nations that aren't sovereign in their own fiat currency system. What ?our means? really refers to is **our real resources and our capacity to produce further real resources in a sustainable way.** It does not refer to financial sustainability, or to fiscal sustainability [26] in the meaning of that term spread by Peter G. Peterson, and Barack "Hoover" Obama [27].

> ?Understand ?- raising the debt ceiling does not allow Congress to spend more money. It simply gives our country the ability to pay the bills that Congress has already racked up. In the past, raising the debt ceiling was routine. Since the 1950s, Congress has always passed it, and every President has signed it. President Reagan did it 18 times. George W. Bush did it seven times. And we have to do it by next Tuesday, August 2nd, or else we won?t be able to pay all of our bills.?

This is one of the biggest falsehoods told by the President. Let's say there is no agreement, then, is it true that we won't be able to pay our bills? Only if the President fails in his own constitutional duty and doesn't take the measures he is able to take to make it possible for Treasury to spend appropriations. Yves Smith, in a recent interview with Paul Jay [28] of the Real News Network, points to three alternatives the President can use: 1) the constitutional challenge; 2) selective default; and 3) Proof Platinum Coin Seigniorage (PPCS).

Yves characterized PPCS as the most "radical" of the three alternatives. Depending on the coin seigniorage option [24] selected, that may be true; but I think that from the legal point of view, at least, PPCS is the least radical of the alternatives. I think that's true because it's the only one of the three that is completely within the law as currently written and interpreted.

The first option, the constitutional challenge, requires violating the debt ceiling, and then claiming that the law is unconstitutional and relying on the House's inability to have standing to take the President to Court in order to sustain the President's action. The President may get away with this, but it is radical in the sense that it claims the Executive's right to make a unilateral judgment of constitutionality in opposition to clearly written legislation, without getting a by your leave from the Supreme Court. Surely we can all see how dangerously radical this kind of practice is for the rule of law in the United States?

The second option, is the Treasury declaring a selective default only on Federal Reserve-owned debt instruments in order to wipe these off the books, and create headroom relative to the debt ceiling. This is clearly an extra-legal procedure. The Federal Reserve Board of Governors is a Government agency; but those bonds are owned by the Fed Regional Banks, which in our system, are not Government agencies, but rather privately owned "Federal instrumentalities." Here's wikipedia [29]:

> "The Federal Reserve Banks have an intermediate legal status, with some features of private corporations and some features of public federal agencies. The United States has an interest in the Federal Reserve Banks as tax-exempt federally-created instrumentalities whose profits belong to the federal government, but this interest is not proprietary.[74] In Lewis v. United States,[75] the United States Court of Appeals for the Ninth Circuit stated that: "The Reserve Banks are not federal instrumentalities for purposes of the FTCA [the Federal Tort Claims Act], but are independent, privately owned and locally controlled corporations." The opinion went on to say, however, that: "The Reserve Banks have properly been held to be federal instrumentalities for some purposes." Another relevant decision is Scott v. Federal Reserve Bank of Kansas City,[74] in which the distinction is made between Federal Reserve Banks, which are federally-created instrumentalities, and the Board of Governors, which is a federal agency."

Since the Bonds held by the Fed are held by the regional banks, this second option would involve a major hit to the assets of these banks and also an operating loss. It would involve not just questioning, but also denying a debt of the United States, and would therefore violate the 14th Amendment to the Constitution. From a legal point of view I think the Treasury unilaterally deciding to inflict a substantial loss on privately owned banks, whether Federal Instrumentalities or not. and also violating the 14th Amendment, is a very radical option.

Getting to the third option of Coin seigniorage, the authority to do this was legislated by Congress in 1996. If the President uses PPCS, he 1) won't exceed the debt ceiling; 2) won't be challenging the constitutionality of the debt ceiling; 3) will be able to spend all Congressional Appropriations; and 4) will be able to uphold his constitutional obligation to see that all US debts are paid. In other words, **there are no legal downsides to this course of action,** even if it may involve a very different way of raising revenue than issuing debt instruments.

On the positive side, if the Administration were to use PPCS, it wouldn't have to make a deal with the Republicans about the debt ceiling at all. It wouldn't have to create hurtful cuts in the safety net or in discretionary programs, because it would not need a deal at all. I've argued elsewhere, that in case there is no agreement on extending the debt ceiling, that it becomes the President's constitutionality duty to use one of a number of PPCS options to avoid default, since only they are unambiguously legal. In that case, some form of PPCS, would no longer be a choice, but a mandate, which the President would have to fulfill.

So, it's not true that we won't be able to pay our bills on August 3rd, if the debt ceiling isn't extended, **unless the President fails in his constitutional duty.** The Congress may be acting stupidly in not extending the ceiling; but in doing so, it would not be forcing the US into default. It would, instead be placing a constitutional burden on the President. It is he who would force the US into default if he fails to shoulder this burden and do his duty.

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