

Why Deficits Don't Matter

By Bob Veres
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Congress is coming off of a bruising debate over the deficit ceiling – a preview of what we will experience again in a few months. The economy is growing slowly – some would say incrementally, after the 16-day government shutdown. Unemployment is a lingering problem, and the Fed's quantitative easing (QE) program works in reverse; that is, instead of boosting economic growth in any visible way, any hint of ending it spooks the markets.

What's to be done about this mess?



Bob Veres

Stephanie Kelton, Associate Professor of Economics at the University of Missouri/Kansas City, believes that the root of all these problems can be found in a fundamental misunderstanding – shared by Democrats, Republicans and mainstream voters alike – about the government's balance sheet. She argues, plausibly, that the whole idea that we should control the deficit at all is costing our nation trillions of dollars in lost output. The result is lost income, savings, wealth and prosperity.

"As a society, we don't understand government finance," says Kelton. "Most people – including most economists, think that it operates by the familiar rules of household finance. Therefore, we find it plausible when we hear politicians and government watchdogs urging us to balance the budget, control the urge to spend and pay down the debt."

The mantra on the right: the federal government has to stop spending money it doesn't have. The mantra on the left: we need higher taxes on "the rich" in order to balance the budget and pay down the federal deficit. Moderates call for a little bit of each.

"We act like there is some limited amount of money available," says Kelton, "and that government competes for savings with the rest of the economy, and that too much competition for savings drives up interest rates, and higher interest rates crowd out all productive private investment. We act like the federal government is walking a fine line between solvency and insolvency – that if the debt gets too big, our creditors may begin to get nervous, downgrade our debt, our interest rates go up, and suddenly we end up like Greece."

Yes. So? "That picture has no economic meaning whatsoever," says Kelton. "None."

Currency by keystrokes

These days, you might see Kelton presenting her out-of-the-box economic perspective at financial industry conferences – most recently at the Financial Planning Association's Retreat and the Northern California



Regional Conference – and you are starting to hear similar ideas expressed in the op-ed pages of the *Financial Times* and other media outlets. She describes herself – and a number of other influential economists – not as a deficit hawk (*Pay off the debt now!*), or a deficit dove (*Pay off the debt as soon as the economy is stabilized!*), but as a deficit owl.

The owls, she says, have a very different way of looking at our economic and policy options. They ask: What if there are no limits on how much money the government has? If that were true, what would you do differently?

Before a reasonable person answers that question, he or she would have to be convinced that there really are no limits. Kelton opens the discussion by noting that the modern financial system is very different from the one on which that many economic textbooks are based. In 1971, the global monetary system changed in a fundamental way when President Nixon took the U.S. dollar off of the gold standard. This ended a system of fixed exchange rates, where other countries pegged their currencies to the U.S. dollar, and through the dollar, to gold.

This much you know. But what were the consequences of that shift? "Uncomfortable and unsettling as it is for many people to contemplate," says Kelton, "we have a true fiat money system. The United States government has something that households don't have. It has the power to create the currency that we all live by."

In the modern era, this doesn't involve printing money; the Federal Reserve credits someone's account with a certain amount of money – and, indeed, those keyboards have been busy since 2008, as the Fed has aggressively stuffed reserves into the accounts of some of the largest banking institutions domiciled in the U.S. Banks, meanwhile, have the authority to credit our accounts with the money we want to borrow, using similar keystrokes. "The idea that bank lending is constrained by the depositors' dollars it takes in is nonsense," says Kelton. This is the insight that led monetary trackers to move past M1 calculations (physical currency plus checking account balances) to the more comprehensive M3 measure, which includes bank reserves and other long-term deposits, plus savings and money market accounts.

Kelton fully understands the discomfort that comes with the realization that the government can actually open up the purse as wide as it wants, so long as somebody has access to the right keyboard.

But get used to it, she says, because that is the system we have today.

Therefore, the government can stimulate the economy at will, pay off our debt obligations and forestall the next round of debt ceiling negotiations. It never has to worry about default so long as it maintains the power to issue money by fiat. This sounds a bit preposterous until you remember that much of what has been said about Greece's debt predicament is the same argument in reverse. Greece cannot control (or print) its own currency, and therefore has been stripped of its main policy option in the wake of massive government debt. It was widely predicted that Greece would bail itself out by leaving the Eurozone and reclaiming the option of printing drachmas and using them to pay off its loans.



Hyperinflation triggers

So is Kelton really saying that government debt doesn't matter to a country that controls its fiat currency? Yes and no. Kelton does not say that deficits don't matter, or that the government should keep on spending money until we get to full employment, or that we can print (or keystroke) our way to prosperity. But she thinks that deficits don't matter as much as most people think, and when they *do* matter, the consequences are different from what most people believe.

To see the world through Kelton's eyes, look at the Eurozone, where each country has to sell goods and services in return for euros, and use those euros to pay off their debts. Bond investors recognize that certain countries (Greece, Spain, Portugal) have been having trouble raising enough euros to service their debt, so these investors, in aggregate, have demanded higher coupon rates for the additional risk.

In the U.S., investors perceive zero risk; Kelton pointed out that U.S. debt-to-GDP ratio is close to 100%, yet short-term interest rates are still roughly what you would get if you buried your money in the backyard. It's the same with Japan, which has a 200% debt-to-GDP ratio.

What do Japan and the U.S. have in common that Europe doesn't have? They control their own currency; that is, neither country has to sell goods and services to obtain dollars or yen. And (despite the recent unpleasantness in Washington) bond investors still, apparently, believe that both Japan and the U.S. are serious about repaying their debt obligations. Debt levels, for countries that control their currency, don't greatly impact demand for government bonds, no matter what dark mutterings you might be hearing about global bond vigilantes or a potential Chinese boycott of Treasury bonds.

But what about the threat of hyperinflation? If inflation, as Milton Friedman once observed, is always and forever a monetary phenomenon, then won't printing (or keystroking) dollars cause consumer prices to skyrocket? Won't we end up like Zimbabwe or the Weimar Republic?

Kelton points to a 2012 report by the Cato Institute—a conservative-leaning think tank—which examined 56 outbreaks of hyperinflation around the world and across history. (You can see a summary of the thinking [here](#) and the report [here](#).) "Not a single one of those 56 cases were caused by a central bank that ran amok," says Kelton. "In virtually every case, the inflation was not caused by too much money, but by too few goods." The collapse of the farming industry in Zimbabwe made food a scarce commodity and paper money practically worthless when trying to purchase it. The Germans lost much of their industrial production after World War I, and what did survive was annexed by France, creating a scarcity of most of the things Germans wanted to buy. What can't be attributed to a production collapse can be traced to causes that have little to do with a market recklessly flooded with currency. The hyperinflation in the Confederate states broke out toward the end of the Civil War, when it became clear that the Confederate notes would soon be backed by a nonexistent government entity.

"Inflation is overwhelmingly driven by cost-push variables," Kelton explains. "Printing money just doesn't do it. If it did, Japan would have exploded decades ago, because they've been trying quantitative easing for nearly 20 years, and they can't move the needle on inflation. We've been trying it here in the U.S. for about five years, and Bernanke can't even hit his 2% inflation target."



Cheering the taper

Speaking of Bernanke, what does an owl economist think of the Fed's stimulus policies? Kelton says flatly that QE doesn't work, because, she says, it doesn't do what the Fed economists think it does. "When QE started, people had one of two reactions," she says. "They either predicted that the U.S. was on the verge of hyperinflation, or they said Whoopee! The recovery is right around the corner! The Fed is going to stuff banks with lots of cash, the banks will use that cash to make loans, people will go out and spend and we're home free."

Kelton is on record having predicted nothing of either sort. "I always explained that QE is just an asset swap," she says. "You're taking Treasury and mortgage-backed securities off the balance sheets of banks and replacing them with reserves at the Fed. They are not, net, getting anything. Not only that," Kelton continues; "you're taking higher-interest-yielding assets away from the banks and replacing them with lower-interest-yielding bank reserves, which is actually sucking around \$60-80 billion dollars of interest income out of the private sector of the economy every year."

Kelton advises us to stop waiting for QE to work, and instead of worrying about tapering, we should be cheering the end of QE as a stimulus for economic activity. "QE actually has a strong deflationary bias, which is something that I was pointing out three years ago, before QE even started," she says. "I said, why on Earth would you do this? It's not going to work, in terms of stimulating the macroeconomy."

As to the Fed's other policy moves, stuffing reserves into the banking system isn't inflationary and doesn't stimulate the economy unless there is commensurate demand for borrowing those reserves – unless, in other words, those reserves actually find their way into the flow of the economy. At the moment, consumers are deleveraging their balance sheets and reducing debt, which means they are not banging on the doors of their local lending institutions. Companies, meanwhile, have so much money on their balance sheets, they have little reason to borrow more. When consumers finish deleveraging and start to buy, when corporate CEOs start investing in factories, equipment, people and buildings to put them in, the economy will finally escape the long shadow of the recession. There will be no reason to have all that money in the banks' reserve accounts.

"The Fed hasn't been successful in trying to achieve its macro goals of lower unemployment and higher inflation because it is the wrong institution to do this," Kelton concludes. "Its policy tools are too weak. Believe me, [Fed Chair Ben] Bernanke isn't lazy; if he could have moved the economic needle by now, he would have."

Mobilizing America's "real" resources

If Uncle Sam does, indeed, hold a blank check in his hand, then what should he do with it? What would be the best way to use this nearly unlimited freedom to create dollars with keystrokes for the benefit of the U.S. and global economy?



Kelton would start by putting an end to the debt-ceiling debates. In fact, she's worried that the federal budget is actually close to being balanced as you read this. "This doesn't get on the nightly news, but the fact of the matter is that the deficit is falling faster, right now in the U.S., than it has fallen at any time since the end of World War II," she says. "And this was true before the fiscal cliff began. It was true before the sequester." (Here's a [link](#) to a recent accounting that shows that the Treasury actually posted a surplus in September, the month before the debt-ceiling debate.)

Why is it falling? "Before we raised taxes, before we slashed spending, the budget deficit was falling because the economy was recovering," Kelton explains. "People were getting jobs again. Instead of losing 800,000 jobs a month, we were gaining more than 200,000 jobs a month. When people get employed and have an income, they start paying taxes again," she adds. "They no longer qualify for unemployment compensation, food stamps, Medicaid and other forms of assistance. Government support spending goes down, taxes go up, and the deficit corrects itself when the economy is healthy and recovering."

But isn't this *good* news? "The Congressional Budget Office projects that this year, 2013, the government's deficit is going to shrink to 3.4% of GDP," says Kelton. "That simply is not sustainable. If the government is only running a deficit that is 3.4% of GDP, but the rest of the world is still running trade surpluses of more than 4.0% against the U.S. economy, that is going to leave, by definition, our domestic private sector in debt. They will be in deficit. We'll go back into recession, the private sector will lose jobs, and then the government's deficit will explode again."

So the first part of the prescription is to allow budget shortfalls at least equal the trade deficits – basically to allow other economies (think: China and Japan) to sell their manufactured products to U.S. consumers in excess of what American consumers buy from them, and force those exporting nations to balance the books by purchasing Treasury bonds paying very low interest rates.

The second part of the prescription is to put more money in the hands of consumers. "I started advocating this nearly five years ago, in June of 2009: a payroll-tax holiday across-the-board, employer and employee," says Kelton. "That would represent a 6.2% across-the-board reduction in the wage bill for every business in the country, and the same time increase take-home pay for folks who work for a living and make less than \$114,000. "If we had done nothing but that, it would have ended the recessionary period long long ago," she says.

There are, of course, limits here. Kelton acknowledges the dangers of giving politicians unlimited power to stuff money into the shirt pockets of their constituents and voters. Wouldn't you vote for the presidential candidate who told you that he or she would keystroke a million additional dollars into your bank account the day after moving into the White House?

Before politicians fully grasp the implications of that blank check in Uncle Sam's hand, Kelton would like to see some limits on how that money would be used. As you read this, she is working on a project with some mathematicians at the Fields Institute in Toronto to put limits on government fiscal policy, based on GDP and inflation levels. "I like the idea of bounding them in some way," she says, "not just limiting what they are able to do, but also maximizing what they're required to do in response to these deviations in those variables from some target level."



Part three of Kelton's prescription is for Congress to authorize some long-delayed infrastructure improvements – exactly what uber-economist Woody Brock has proposed in an earlier [article](#) in *Advisor Perspectives*. The goal is to use the newly-keystroked money to make use of what Kelton calls "our nation's real resources" in a way that would not create inflationary pressures.

Real resources? "Right now we have factories operating at a fraction of their capacity, and 23 million Americans who want full-time work and can't find it," says Kelton. "We have the Caterpillar machines to move the earth around, and we have architects and engineers who are out of work, we have construction and manufacturing workers. We have steel and concrete. These are not things that are in short supply. We have all these raw materials that are available. We have useful things for people to do and we have the stuff available to do those things. All we lack is the willingness to spend the money to get all these resources in gear."

In gear to do what? "Look around," Kelton proposes, "and you see aging water-treatment facilities, crowded airports and hospitals, crumbling bridges, levies, all this stuff that the engineers look at when they put out the National Infrastructure Report Card. They give us a score of D+ – and they tell us that we need \$3.6 trillion in investments in our national infrastructure just to get up to snuff," adds Kelton. "These are not projects that are going to get done by the private sector. These *have* to be undertaken by the public sector.

"It is useful work," she adds, "and we have the resources to do it, yet we don't do it. Why? Because we have the mental image of Uncle Sam with his pants pockets turned inside out, and how can we pay for it? Until we can answer that simple question: how would we pay for it? We can never do it.

"So they end up arguing over whether, if you want to do something, you have to raise somebody's taxes," Kelton continues. "No you don't. They say: if you want to do something, you have to cut some other program to free up the money to do it. No, you don't."

No limits

The Deficit Owl formula can be summed up: You ramp up the economy by creating more dollars, and put them – and a lot of people – to work without worrying about ramping up inflation. After the economy has recovered, you don't need to go into deficit spending or keystroke more dollars, and so the inflation effect goes away.

Kelton is arguing that we have missed, and are missing, the opportunity to get back on the fast economic growth track simply because we (voters, politicians and most macroeconomists) are locked in a mindset that ignores reality. This is true even though we understand at a gut level that the U.S. and Japan are different from Greece (which cannot print or keystroke euros); even though we know that the government manufactures our currency; even though we have never been aware of any limit to how many dollars can be issued.



To show that the truth is in plain sight, Kelton offers some quotes – from the Constitution, saying that the U.S. government grants itself the sole authority to create the currency, from Alan Greenspan saying that Social Security obligations can always be met because the government can always supply the dollars it is obligated to pay, and a quote from a report issued by the St. Louis Federal Reserve Bank: "As the monopoly issuer of the currency, the United States government can never go broke, can never become insolvent, can never be forced to miss a payment, you can never run out."

We have some historical examples. "There has only been one time in our country's history where – under Andrew Jackson – we actually paid off the national debt completely," says Kelton. "And we had a terrible depression immediately following that. We have never done it again." There have been analyses. "A really nice [piece](#) was written by a hedge fund guy, who basically asked: What would happen if the Bank of Japan monetized its entire outstanding government bond market (JGB) debt?" says Kelton. "His answer was: probably nothing. If we did that here, we would just be replacing U.S. Treasury securities with reserve balances at the Fed. It is either the Treasury that pays the interest, if it is on securities, or it is the Fed that will pay the interest if it is on excess reserve balances. It is just, which set of books do you want to record it on? And it doesn't really matter."

The challenge," Kelton says, is getting this viewpoint into the public policy debates when the voters have been told by the press, pundits and politicians that the government's resources are limited. "It is hard work to deprogram decades of: the government is like a household," Kelton laments. "It's wrong, and you should say that it's wrong. And we should help people understand what the real choices are, and then we should make policy that makes sense. We aren't doing that. We are following the advice of economists who have a gold standard view of the world. This is like flat-earth economics," she says, "and it's costing us trillions of dollars worth of prosperity."

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